(8)

No. 89-255-CFX
Status: GRANTED

Title: United States, Petitioner
v.
Energy Resources Co., Inc., et al.

Docketed:
August 7, 1989

Court: United States Court of Appeals
for the First Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Moss,Guy B., McGowan,Matthew J.

Entry	Date	Note	Proceedings and Orders
1	Jun 16 1989	G	Application (A88-1011) to extend the time to file a petitic for a writ of certiorari from June 29, 1989 to August 1989, submitted to Justice Brennan.
2	Jun 19 1989		Application (A88-1011) granted by Justice Brennan extending the time to file until August 8, 1989.
3	Aug 7 1989	G	Petition for writ of certiorari filed.
6	Sep 6 1989		Order extending time to file resonse to petition until October 20, 1989 for all respondents.
7	Oct 20 1989		Brief of respondent Energy Resources Co., Inc. in oppositic filed.
8	Oct 25 1989		DISTRIBUTED. November 9, 1989
9	Nov 3 1989		Reply brief of petitioner United States filed.
10	Nov 13 1989		Petition GRANTED.
			**********
11	Nov 27 1989	G	Motion of the Solicitor General to dispense with printing the joint appendix filed.
13	Dec 7 1989		Record filed.
		*	Certified copy of original record and C. A. Proceedings received.
12	Dec 11 1989		Motion of the Solicitor General to dispense with printing the joint appendix GRANTED.
15	Dec 28 1989		Brief of petitioner United States filed.
16	Jan 18 1990		Brief amicus curiae of GLK, Inc. filed.
17	Jan 26 1990		SET FOR ARGUMENT MONDAY, MARCH 19, 1990. (1ST CASE)
18	Feb 2 1990		Brief of respondents Energy Resources Co., Inc., et al. filed.
19	Feb 14 1990		Record filed.
		*	Certified copy of docket entries, clerk's certificate & documents, 4, 6, 8, 11,12, 14, 15 & 17.
20	Feb 15 1990		CIRCULATED.
21	Mar 2 1990		Record filed.
		*	Certified copy of original record received.
22	Mar 7 1990	X	Reply brief of petitioner United States filed.
23	Mar 19 1990		ARGUED.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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QUESTION PRESENTED

Whether a bankruptcy court may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability, thereby relieving the corporation's responsible persons of their separate liability for those taxes.

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NEWPORT OFFSHORE, LTD.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The Solicitor General, on behalf of the United States of America,[1] petitions for writs of certiorari to review the judgments of the United States Court of Appeals for the First Circuit in these cases.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-23a) is reported at 871 F.2d 223. In the *Energy Resources* case the opinion of the district court (App.,

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[1] The Internal Revenue Service was erroneously named as the governmental party in the Energy Resources litigation. Accordingly, we have substituted the United States as the proper party in the caption of *Energy Resources*.

infra, 24a-26a) is unreported; the opinion of the bankruptcy court (App., *infra*, 31a-41a) is reported at 59 Bankr. 702. In the *Newport Offshore* case, the oral opinion of the district court (App., *infra*, 27a-30a) is unreported; the opinion of the bankruptcy court (App., *infra*, 42a-50a) is reported at 75 Bankr. 919.

JURISDICTION

The judgments of the court of appeals (App., *infra*, 51a-52a) were entered on March 31, 1989. On June 19, 1989, Justice Brennan extended the time to petition for writs of certiorari to and including August 8, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

Section 105 of the Bankruptcy Code, 11 U.S.C. 105 (Supp. V 1987), provides in pertinent part:

Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.

* * * * *

Section 507 of the Bankruptcy Code, 11 U.S.C. 507 (Supp. V 1987), provides in pertinent part:

Priorities

(a) The following expenses and claims have priority in the following order:

* * * * *

(7) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for—

* * * * *

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

* * * * *

Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129 (Supp. V 1987), provides in pertinent part:

Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

* * * * *

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

* * * * *

(C) with respect to a claim of a kind specified in section 507(a)(7) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

* * * * *

STATEMENT

These two cases were consolidated for purposes of argument and decision in the court of appeals. Both cases involve corporations that are in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*) and that owe the government both trust fund and non-trust fund taxes. Trust fund taxes are those taxes withheld from the wages of employees and held by the em-

ployer in trust for the government under Section 7501 of the Internal Revenue Code (26 U.S.C.).[2] If the persons responsible to collect, account for, and pay over trust fund taxes to the government willfully fail to do so, they each become personally liable under 26 U.S.C. 6672 for a penalty in the full amount of the unpaid trust fund taxes. Since the government collects the amount of the unpaid trust fund taxes only once (see *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 (5th Cir. 1986)), the Section 6672 liability of each "responsible person" is reduced to the extent that the trust fund taxes are paid by the corporation.

1. In January 1983, respondent Energy Resources Company and its affiliates filed petitions for reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*). At that time, respondent owed about $1 million in taxes, most of which were trust fund taxes. App., *infra*, 5a. Under Chapter 11 as in effect at that time, these taxes were entitled to a "sixth priority" (11 U.S.C. 507(a)(6)).[3] Chapter 11 requires as a condition of confirmation that a reorganization plan provide for the payment of all priority tax liabilities over a period not to exceed six years (11 U.S.C. 1129(a)(9)(C)).

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[2] Sections 3102 and 3402 of the Internal Revenue Code (26 U.S.C.) require employers to deduct from wages certain amounts for the employees' income taxes and for the employees' portion of social security taxes. These amounts are to be "held * * * in trust" for the United States and later paid over to the government by the employer (26 U.S.C. 7501). Other corporate tax liabilities that are not withheld from employees' wages, such as corporate income tax and the employer's share of social security taxes, are referred to as "non-trust fund" taxes.

[3] Due to a 1984 amendment that added a new category of priority claims, priority federal tax claims are now seventh priority claims. See 11 U.S.C. 507(a)(7) (Supp. IV 1986).

a. The bankruptcy court confirmed Energy Resources' third amended plan of reorganization. That plan provided that most of the debtor's assets would be transferred to the ERCO Liquidation Trust, and thereafter liquidated under the supervision of a liquidation trustee for payment to creditors of the estate. The plan provided for the payment of pre-petition tax claims, with interest, from the liquidation trust in four annual installments beginning on the anniversary of the confirmation date, October 1, 1984. The trustee could prepay the taxes at any time. App., *infra*, 5a, 32a.

On November 6, 1985, the trustee made a payment of the pre-petition federal tax claims totalling $281,517. The trustee designated "that this payment be applied to the trust fund portion of the taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982." App., *infra*, 33a. The Internal Revenue Service (IRS) refused to accept the trustee's designation, maintaining that it had the right to apply the payment to the corporate debtor's oustanding tax liability as it chose. The IRS informed the trustee by letter that, "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment[,] which is a distribution of a bankruptcy proceeding[,] to its maximum benefit." *Ibid.*

The trustee thereupon moved the bankruptcy court for an order directing the IRS to apply payments under the plan according to the trustee's designation. In his motion, the trustee argued that he was entitled to designate tax payments under the plan because the payments were "voluntary." He also contended that the designation of payments was necessary for the benefit of the bankruptcy estate. He stated that the designation enabled him to implement a settlement agreement entered into with Richard

Rosen, a former officer of the debtor, in which Rosen immediately released $14,000 to the trust, assertedly in exchange for the trustee's agreement "to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them." The trustee also asserted that the designation would not harm the IRS because the plan provided, ultimately, for payment of the tax claims in full. The IRS opposed the trustee's motion on the ground that the payment of priority taxes under a Chapter 11 plan is involuntary and therefore the IRS is permitted to apply the payment as it chooses. App., *infra*, 33a-34a.

b. The bankruptcy court granted the motion and ordered the IRS to follow the trustee's designation (App., *infra*, 31a-41a). The court stated the general rule that a taxpayer who makes a "voluntary" tax payment is entitled to designate the manner in which it is to be applied, whereas that authority rests with the IRS if the payment is "involuntary" (*id.* at 34a). Relying on several other bankruptcy court decisions, the court held that "the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary" (App., *infra*, 36a), and therefore the trustee was entitled to designate how the tax payment should be applied (*id.* at 36a-40a). The court also stated that its conclusion was buttressed by the government's failure to object to confirmation of the plan, even though the plan was silent on the question of designation or the manner in which the tax payments should be applied, because it was "foreseeable" that the trustee would seek such a designation (*id.* at 40a-41a).

c. On appeal, the district court affirmed (App., *infra*, 24a-26a). The court stated that the bankruptcy court's role in confirming a plan under Chapter 11 does not make a

tax payment thereunder involuntary because the Bankruptcy Code affords debtors considerable flexibility in Chapter 11. Thus, in the district court's view, the bankruptcy "court here didn't compel the action; rather, it approved a payment which a debtor wished to make" (App., *infra*, 26a).

2. a. In the *Newport Offshore* case, respondent Newport Offshore filed a petition for reorganization under Chapter 11 on November 13, 1985, and continued operating as a debtor-in-possession. The trustee proposed a plan of reorganization under which a third party, Allied Marine Associates, agreed to pay all of respondent's pre-petition tax liability and various other debts, and to invest additional money in the corporation; in return, it would receive 85% of the shares of the new, reorganized Newport Offshore. The proposed plan provided for full payment of pre-petition priority tax claims over a period of about six years. It further provided that these payments would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the taxes (App., *infra*, 5a). The government objected to the designation provision on the same grounds that it raised in *Energy Resources*.

b. The bankruptcy court overruled the government's objection (App., *infra*, 42a-50a). The court declined to adopt respondent's contention that tax payments under a Chapter 11 plan always may be designated by the debtor because there is no "enforced collection measure" that makes them involuntary (see *id.* at 45a-46a). Instead, the court concluded that whether a Chapter 11 debtor may designate its tax payments should be decided on a case-by-case basis according to the "totality of the facts and circumstances" (*id.* at 47a).[4] The court expressed the concern

[4] The court listed several factors that it regarded as relevant to this analysis, including: (1) the history of the debtor; (2) whether the

that, if payments of priority taxes in Chapter 11 cases were always held to be involuntary, it "would remove the initiative of [the debtor's] former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan" (*id.* at 48a). The court concluded that the existence of third-party financing constituted "special circumstances" that justified including the trustee's requested designation provision in the plan (*ibid.*).

c. Ruling from the bench, the district court reversed and ordered the bankruptcy court to delete the designation provision from the reorganization plan (App., *infra*, 27a-30a). Relying on the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987), the court concluded that advancing the policy of reorganization did not require permitting the designation provision at issue, which would undermine the policy of collecting taxes (App., *infra*, 29a). The court concluded that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (*id.* at 29a-30a).

3. On consolidated appeals, the court of appeals affirmed in the *Energy Resources* case and reversed in the *Newport Offshore* case (App., *infra*, 1a-23a). The court stated that whether payments made pursuant to a Chapter 11 reorganization plan should be characterized as "voluntary" or "involuntary" depends upon the degree of control

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IRS had taken any pre-bankruptcy collection measures; (3) the nature of the Chapter 11 plan; (4) the extent of administrative or court action; and (5) the "existence of exceptional or special circumstances warranting [the] allocation provided by the plan." App., *infra*, 47a n.7.

the bankruptcy court has over the payments at issue, and it found that a Chapter 11 proceeding exhibits some characteristics that are "voluntary" and others that are "involuntary." Recognizing the deference due the IRS's interpretation on this matter, the court declared that it accepted the view that payments made pursuant to a Chapter 11 plan are "involuntary." *Id.* at 7a-12a. The court determined, however, that this conclusion was not dispositive because it "only means * * * that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue" (*id.* at 12a). The court then proceeded to hold that the bankruptcy courts were empowered to require the IRS to apply the tax payments first to the trust fund tax liability. The court acknowledged that this holding was inconsistent with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, *supra*, which had been followed by two other circuits (App., *infra*, 4a).

The court of appeals viewed the governing question as (App., *infra*, 12a-13a): "Does a bankruptcy court possess the legal power to order the IRS to apply a payment in a way that runs *counter* to IRS's own internal policies?" The court listed several factors it considered significant in concluding that bankruptcy courts do have the power to override the IRS's traditional authority to apply involuntary tax payments as it chooses.

First and foremost, the court stated that "Congress has granted bankruptcy courts broad equitable powers" (App., *infra*, 13a). In particular, the court pointed to the bankruptcy court's power to " 'issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions' of the Bankruptcy Code" (*ibid.*, quoting 11 U.S.C. 105 (emphasis by the court)). As an example of when "an order allocating Chapter 11 tax payments to 'trust fund' liabilities first would seem 'appropriate,' " the

court posited the situation where the responsible officers offer to help rehabilitate the debtor by advancing funds, but "only if the court would assure them that the reorganized corporation would pay its 'trust fund' tax debts first" (App., *infra*, 13a-14a). In that situation, the court reasoned, the bankruptcy court could determine that the diminished chances that the government would collect its entire tax debt would be outweighed by the increased chances that the debtor would pay something to its general creditors (*id.* at 14a).

In the court's view, the other factors that it listed buttressed this conclusion regarding the bankruptcy court's power. The court stated that the bankruptcy courts have long had the legal power to tell creditors how to apply payments against the debtor's several debts (App., *infra*, 14a-15a) and that nothing in the Bankrutpcy Code limits the bankruptcy court's designation power when the creditor is the IRS (*id.* at 15a-16a). The court reasoned that "it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of Chapter 11 tax payments" because it is equipped to consider the effect of that determination on the debtor's prospects for rehabilitation and already has the power to structure the timing of tax payments within the six-year constraint of 11 U.S.C. 1129 (App., *infra*, 16a).

The court further noted that the IRS's policy of allocating payments first to non-trust fund taxes, while clearly calculated to maximize the collection of delinquent taxes, was not embodied in any statute (App., *infra*, 16a-17a). Finally, the court stated that it could "find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here" (*id.* at 17a). In particular, the

court stated that the strong congressional policy of ensuring the collection of trust fund taxes embodied in 26 U.S.C. 6672 would not be undermined by its decision because the designation provided for the collection of trust fund taxes first, albeit at the expense of non-trust fund taxes that would go unpaid if the reorganization failed, while the IRS's allocation postponed the collection of trust fund taxes (App., *infra*, 17a-20a).

Accordingly, the court of appeals concluded that the bankruptcy courts have the legal power to order the allocation of involuntary tax payments in Chapter 11 proceedings. The court held that the allocation question should be determined by the bankruptcy court on a case-by-case basis, subject to review under the clearly erroneous standard. App., *infra*, 21a. And the court specified the following as the appropriate inquiry (*ibid.*): "upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money?" The court concluded that it was unnecessary to remand the cases, holding that the bankruptcy courts' opinions indicated that they both would have upheld the requested designations under the standard promulgated by the court of appeals (*id.* at 21a-23a).

REASONS FOR GRANTING THE PETITION

The court of appeals has erroneously decided an important and frequently recurring question of federal law, in direct confict with the decisions of other courts of appeals. The court has held that bankruptcy courts have dis-

cretion to allow a corporate debtor in Chapter 11 proceedings to designate priority federal tax payments under its reorganization plan for application first to trust fund tax liability. The effect of this decision is to sanction the use of Chapter 11 by officers of the corporate debtor to reduce or eliminate their potential personal liability for delinquent trust fund taxes and thereby undermine the separate source of collection of those taxes and the deterrent to their misuse that has been established by Congress. As a result, tax payments under Chapter 11 plans would, as a practical matter, first redound to the benefit of the corporate officers, not the government. If the plan were not successfully completed, the government would still be left with an uncollectible non-trust fund tax claim, while the corporate officers would have been relieved of their trust fund liability to the extent payments have been made. In light of the frequency with which this issue recurs, it is essential that the conflict in the circuits be resolved and that a uniform rule be established to guide the conduct of Chapter 11 proceedings.

1. The court of appeals acknowledged (App., *infra*, 4a) that the decision below directly conflicts with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987). It similarly conflicts with the Sixth Circuit's decision in *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (1988). In each of those cases, as here, the government objected to a proposed Chapter 11 plan that provided that payments of priority taxes were to be applied first to the trust fund portion of the outstanding tax liability. Both courts of appeals determined that tax payments made pursuant to a Chapter 11 plan are not voluntary and therefore may be allocated as the IRS determines. *In re Ribs-R-Us, Inc.*, 828 F.2d at 201-203; *DuCharmes & Co.* v. *Michigan*, 852 F.2d at 196. Pointing to the debtor's failure to produce evidence "that suggests that Congress intended by the

Bankruptcy Code to curtail the IRS's longstanding ability to use 26 U.S.C. § 6672 to provide a collateral source for collection of trust fund taxes," the Third Circuit held that "no provision of the Bankruptcy Code allows either the debtor or the bankruptcy court to direct application of payments and thereby preclude recourse by the United States against responsible parties" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204 & n.4). The court concluded that permitting the debtor to designate the portion of its tax liability to which payments should be allocated would be "in derogation of Congress' strong policy, reflected in section 6672, to protect the government's tax revenues by insuring an additional source from which trust fund taxes can be collected" (*id.* at 204). The Third Circuit also criticized the approach of permitting designation on a case-by-case basis, which was approved by the court of appeals below; it explained that "[a] uniform federal rule is preferable so that debtors, creditors, and the Internal Revenue Service will be able to know in advance whether the debtor can make such a designation and guide their decisions accordingly" (*id.* at 202).

The decision below is also inconsistent with the Ninth Circuit's decision in a slightly different context in *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (1987). In that case, a debtor filed a petition for relief under Chapter 11 and then, before the confirmation of its reorganization plan, filed a motion asking that it be permitted to make payments to the IRS designated for application to its trust fund tax liability. Rejecting the IRS's objection, the bankruptcy court ordered the IRS to apply any such payments according to the debtor's requested designation. The court of appeals reversed, finding that those payments would be "involuntary" and that the bankruptcy court's equitable powers do not permit it to enforce such a designation. The court explained that, once

a debtor invokes the assistance of the bankruptcy court to keep its creditors at bay by filing a Chapter 11 petition, it can no longer claim that its tax payments are voluntary, and it "is not free to abuse this system by designating its payments in a way that benefits only its responsible persons, and possibly harms other creditors, including the IRS, without the scrutiny of the court or other creditors" (833 F.2d at 803).[5]

In addition to these court of appeals decisions, the question presented here has been addressed with varying results by numerous lower courts.[6] Thus, there exists an acknowledged conflict in the circuits and considerable disarray in the lower courts on an important and frequently recurring issue. It is therefore necessary for this Court to resolve the conflict and provide a uniform rule to guide the lower courts in dealing with attempts by Chapter 11 corporate debtors to protect their officers' personal funds by designating priority tax payments for application first to trust fund tax liability.

[5] The result reached by the court below is consistent with that reached by the Eleventh Circuit in *United States* v. *A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (1987), vacated, 108 S. Ct. 1724 (1988), on remand, 861 F.2d 1538 (1988). On the government's petition for a writ of certiorari, that decision, which upheld the bankruptcy court's discretion to order the IRS to comply with the debtor's designation, was vacated by this Court in light of the debtor's declaration that it was no longer interested in enforcement of the designation provision. The reorganization plan ultimately was amended to remove that provision.

[6] The following cases have held payment of priority taxes in bankruptcy to be subject to application as the IRS determines on the ground that the payments are involuntary: *In re Frank Meador Buick, Inc.*, No. 88-349-R (W.D. Va. Mar. 16, 1989), rev'g 85 Bankr. 392 (Bankr. W.D. Va. 1988), appeal pending, No. 89-2954 (4th Cir.); *In re Intermarket, Inc.*, 93 Bankr. 70 (D.Md. 1988); *In re Professional Technical Services, Inc.*, 94 Bankr. 578 (E.D. Mo. 1988); *In re Vermont Fiberglass, Inc.*, 88 Bankr. 41 (D. Vt. 1988); *In re McCom Communications, Inc.*, 76 Bankr. 180 (N.D. Ala. 1987); *In re Mister Marvins, Inc.*, 48 Bankr. 279 (E.D. Mich. 1984); *In re Frost*, 47 Bankr. 961 (D. Kan. 1985); *In re Avildsen Tools & Machines, Inc.*, 40 Bankr. 253 (N.D. Ill. 1984), aff'd on other grounds, 794 F.2d 1248 (7th Cir. 1986); *In re Vincent-McCall Co.*, 68-2 U.S. Tax Cas. (CCH) ¶ 9591 (E.D. Wis. 1986); *In re Puget Sound Plywood, Inc.*, 89-1 U.S. Tax Cas. (CCH) ¶ 9240 (Bankr. W.D. Wash. 1989); *In re Shoup's Food Service, Inc.*, 96 Bankr. 767 (Bankr. W.D. Mich. 1988); *In re Jehan-Das, Inc.*, 91 Bankr. 542 (Bankr. W.D. Mo. 1988), aff'd, No. 89-3030-CV-S-2 (W.D. Mo. May 8, 1989), appeal pending, No. 89-1859 (8th Cir.); *In re R.L. Inge Development Corp.*, 78 Bankr. 793 (Bankr. E.D. Va. 1987); *In re Tam Specialty Co.*, 85-2 U.S. Tax Cas. (CCH) ¶ 9758 (Bankr. N.D. Cal. 1985); *In re Obie Elie Wrecking Co.*, 35 Bankr. 114 (Bankr. N.D. Ohio 1983); *In re Hubler Rentals*, 79-2 U.S. Tax Cas. (CCH) ¶ 9621 (E.D. Pa. 1979). The following decisions have held such payments to be voluntary and thus subject to designation by the debtor or the bankruptcy court: *In re Lifescape, Inc.*, 54 Bankr. 526 (Bankr. D. Colo. 1985); *In re Tom LeDuc Enterprises, Inc.*, 47 Bankr. 900 (W.D. Mo. 1984). The following cases have held, like the court of appeals below, that allocation of payments is within the discretion of the bankruptcy court: *Hineline* v. *Household Fin. Corp.*, 72 Bankr. 642 (N.D. Ohio 1987); *In re B & P Enterprises, Inc.*, 67 Bankr. 179 (Bankr. W.D. Tenn. 1986).

2. a. The court of appeals erred in holding that the bankruptcy court has the power to direct the IRS to allocate a corporate debtor's involuntary tax payments first to the debtor's trust fund tax liability, so as to eliminate the corporate officers' personal liability for those taxes. The IRS's longstanding policy has been to permit taxpayers to designate the application of tax payments that are voluntarily made. See Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43, superseding Rev. Rul. 58-239, 1958-1 C.B. 94. The IRS's policy, however, does not permit the taxpayer to designate involuntary payments which traditionally have been viewed as including payments received as a result of a levy or legal proceeding in which the government is seeking to

collect its delinquent taxes. See *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966). This policy, which has generally been approved by the courts, encourages taxpayers to make voluntary payments. See, *e.g.*, *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *Amos* v. *Commissioner*, 47 T.C. at 69-70. In particular, when a corporation is in financial distress, this policy encourages responsible persons to resist the temptation to borrow money from the government's trust fund, *i.e.*, to pay business expenses with taxes that have been withheld from employees' wages. Instead, the officers are motivated to turn those withheld taxes over to the government in a timely fashion so that they can avoid the prospect of personal liability under 26 U.S.C. 6672. Such voluntary compliance with the trust fund structure avoids the expenditure of government resources on collection by means of administrative levy or judicial proceedings. See, *e.g.*, *In re Ribs-R-Us, Inc.*, 828 F.2d at 201-202; *In re Avildsen Tools & Machines, Inc.*, 794 F.2d 1248, 1251 (7th Cir. 1986).

The court of appeals disregarded this established framework by permitting a corporate debtor, with the approval of the bankruptcy court, to designate the application of tax payments that the court acknowledged were involuntary. This decision severely undermines the salutary policy goals that are advanced by the established differential treatment of voluntary and involuntary payments. The incentive for the debtor to make its tax payments voluntarily prior to bankruptcy is removed; despite its decision to default on its taxes and instead to pay them only as required by statute as a condition of confirmation of its reorganization plan, the debtor retains the power to designate its payments as if it had paid the taxes voluntarily. Specifically, the ability later to make the particular designation approved here significantly reduces the likelihood that a failing corporation will pay over to the government the taxes that it has withheld from its employees. Knowing that there will be the opportunity in Chapter 11 proceedings to designate payments first for trust fund taxes substantially weakens the disincentive for corporate officers to use the trust fund in a last-ditch effort to alleviate a corporation's pre-bankruptcy financial difficulties. The specter of Section 6672 liability would be removed as a deterrent to the conversion of trust funds if the responsible persons believe that they can ultimately escape liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable.

The decision below also undermines the congressional policies favoring collection of trust fund taxes and of federal tax liabilities in general in bankruptcy proceedings. Congress viewed the conversion by employers of monies held in the trust fund as a particularly severe type of tax delinquency. Taxes that are withheld by an employer from its employee's wages are credited by the government to that employee's account as paid, whether or not the withheld funds are actually paid over to the government by the employer. Accordingly, the loss from the employer's failure to turn over those trust fund taxes is suffered directly by the Treasury. See 26 U.S.C. 31(a); *Slodov* v. *United States*, 436 U.S. 238, 243 (1978). To prevent such losses, Congress enacted Section 6672 to impose personal liability in the amount of delinquent withholding taxes directly upon the persons responsible for not turning them over to the government. This provision establishes not only an alternative means of collection but also a strong disincentive to corporate officers to draw upon withheld taxes to alleviate a corporation's financial difficulties. See *Slodov* v. *United States*, 436 U.S. at 243; *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978).

The decision below, however, allows responsible persons to use the corporate Chapter 11 proceedings as a shield to protect themselves from Section 6672. The designation sought here benefits the responsible persons of the corporation (by reducing their Section 6672 liability) while providing, at most, only a speculative benefit to the corporation. At the same time, it compromises the protection afforded the public fisc by Section 6672. Corporate tax payments that would otherwise be applied to reduce the corporation's other tax liabilities for which there is no alternative means of collection will instead be applied first to reduce the potential exposure of the corporate officers for the delinquent trust fund liabilities. Thus, in the event the delinquent taxes are only partially paid under the reorganization plan, the Treasury will suffer a loss.

b. The bankruptcy court lacks authority to direct the IRS to allocate payments first to the outstanding trust fund liability. Clearly, there is no provision expressly conferring this authority, and the court of appeals erred in reading such authority into 11 U.S.C. 105, which empowers bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." That general provision speaks to the procedural powers of the court; the legislative history explains that it is designed to extend the power of the All Writs Act (28 U.S.C. 1651) to bankruptcy courts, as well as to cover any other powers traditionally exercised by bankruptcy courts under the old Bankruptcy Act. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 316-317 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 29 (1978). Thus, the courts have recognized that the purpose of Section 105 is to allow the bankruptcy court to issue equitable orders such as injunctions and stays and to punish contempt in cases where such orders are consistent with the Bankruptcy Code; its purpose is not to give the bankruptcy court

leeway to create new substantive rights for debtors. See, *e.g.*, *Bird* v. *Carl's Grocery Co.* (*In re NWFX, Inc.*), 864 F.2d 593, 595 (8th Cir. 1989); *Official Committee of Equity Security Holders* v. *Mabey*, 832 F.2d 299, 302 (4th Cir. 1987); *United States* v. *Sutton*, 786 F.2d 1305, 1307-1308 (5th Cir. 1986).

The designation orders approved by the court of appeals here plainly fall outside the scope of this authority. The bankruptcy court does not have "a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d at 1308) or to issue any order that conceivably could aid the rehabilitation of the debtor. Rather, it is bound to implement the substantive rules established in the Bankruptcy Code and to observe other requirements of law. The designation order here does not help to "carry out the provisions" of the Bankruptcy Code (11 U.S.C. 105); indeed, it runs counter to the Code provisions that seek to secure the payment of delinquent taxes. The Bankruptcy Code establishes a priority system for the payment of outstanding debts in which the taxes owed by respondents are accorded a high priority (see 11 U.S.C. 507(a) (1982 & Supp. V 1987)); thus, it is not appropriate for the bankruptcy court to upset settled rules in order to enhance the prospects of unsecured creditors at the acknowledged expense of the IRS's ability to collect its priority taxes (see App., *infra*, 21a).

In enacting the Bankruptcy Code, Congress weighed the government's right to collect its taxes against the competing interests of the general creditors in collecting their debts and the debtor's desire to obtain a "fresh start." See *e.g.*, S. Rep. No. 989, *supra*, at 13-14. There is no suggestion, however, that Congress intended to confer upon the bankruptcy court power to designate tax payments, to the detriment of the IRS's ability to collect taxes, in order to entice responsible persons to release claims against the

debtor or to cooperate in obtaining financing. It is undoubtedly true that the success of a reorganization may be jeopardized if the debtor's officers are, for whatever reason, unwilling to cooperate fully in the reorganization. But that does not give the bankruptcy court carte blanche to enter orders designed to secure such cooperation by assisting the officers at the expense of another party to the bankruptcy. As the district court stated in *Newport Offshore* (App., *infra*, 29a-30a), Congress did not "intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in Bankruptcy Court an exculpatory provision with respect to the trust fund taxes."[7] The general principle regarding the allocation of involuntary tax payments should be fully applicable here, and a corporate debtor in Chapter 11 should not be permitted to insist on application of its payments first to trust fund taxes in order to eliminate its officers' Section 6672 liability.

3. Resolution of the question presented here is of great importance to the administration of the tax laws. The issue of the validity of a corporate designation in a Chapter 11 plan is one that frequently recurs because most corporate bankruptcies involve withholding tax liability, and the lower courts are in considerable disarray on the issue. Thus, resolution of the conflict will eliminate disparate

[7] Indeed, those responsible persons would not be able to obtain that relief in their own personal bankruptcy proceedings. Section 6672 liabilities would be entitled to priority of payment in those proceedings and, to the extent not satisfied therein, they would not be dischargeable, but would remain an enforceable debt after bankruptcy. See 11 U.S.C. 507(a)(7)(C), 523(a)(1) (1982 & Supp. V 1987). It is inappropriate for the bankruptcy court to permit the same officers to use the threat of noncooperation in the corporate debtor's reorganization to achieve personal relief that they could not obtain in their own bankruptcy proceedings.

results among taxpayers depending upon the jurisdiction in which they file their Chapter 11 petition. Moreover, the issue has significant fiscal impact upon the government. When a Chapter 11 reorganization fails after a few payments are made, as many of them do,[8] the effect of the designation is to reduce the total amount of the outstanding tax liability that may be collected by the government because of the reduction in the responsible persons' Section 6672 liability.[9] Allowing such a designation thus shifts the risk of failure of the plan from the responsible officers, whose improper conduct created the delinquency in the first place, to the government. And, as we have explained (pp. 16-17, *supra*), it would also tend to increase arrearages in trust fund payments by reducing the officers' incentive to make voluntary payments prior to bankruptcy. At all events, resolution by this Court of the conflict in the courts of appeals is required if there is to be even-handed administration of the tax and bankruptcy laws.

[8] The Administrative Office of the United States Courts has estimated that 90% of Chapter 11 reorganizations fail. See *In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 382 (5th Cir. 1987) (Jones, J., dissenting), aff'd, 108 S. Ct. 626 (1988). Indeed, if there were not a considerable likelihood that the plan would fail, the designation issue would be of no concern to the responsible officers since the plan must provide for the payment of all trust fund taxes by the corporate debtor within six years.

[9] The Collection Division of the IRS estimates that up to $34 million per year in tax revenue could be lost if designations are permitted routinely.

CONCLUSION

The petition for writs of certiorari should be granted.
Respectfully submitted.

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AUGUST 1989

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 87-1896

IN RE ENERGY RESOURCES CO., INC., DEBTOR

INTERNAL REVENUE SERVICE, PLAINTIFF, APPELLANT

v.

ENERGY RESOURCES, CO., INC., DEFENDANT, APPELLEE

APPEAL FROM THE UNITED DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[Hon. John J. McNaught, *U.S. District Judge*]

No. 88-1175

IN RE NEWPORT OFFSHORE, LTD., DEBTOR

UNITED STATES OF AMERICA, PLAINTIFF, APPELLEE

v.

NEWPORT OFFSHORE, LTD., DEFENDANT, APPELLANT

APPEAL FROM THE UNITED DISTRICT COURT
FOR THE DISTRICT OF RHODE ISLAND
[Hon. Francis J. Boyle, *U.S. District Judge*]

March 31, 1989

Before: Bownes and Breyer, *Circuit Judges*, and Caffrey,* *Senior District Judge*

BREYER, *Circuit Judge*. The Internal Revenue Code requires employers to withhold from their employees' paychecks money representing employees' personal income taxes, unemployment insurance and social security taxes that those employees owe or will owe the government. 26 U.S.C. §§ 3102(a), 3402(a) (1982). Because federal law requires employers to hold these funds in "trust for the United States," 26 U.S.C. § 7501(a) (1982), these taxes are commonly referred to as "trust fund" taxes. *Slodov* v. *United States*, 436 U.S. 238, 242-43 (1978). And, should employers fail to pay them, the government can collect an equivalent sum directly from the officers or employees of the employer who are responsible for their collection and payment. 26 U.S.C. § 6672 (1982). These individuals are commonly referred to as "responsible" individuals. *Slodov*, 436 U.S. at 244 n.5. An employer, of course, may also fail to pay the government its ordinary corporate income tax or other "non-trust fund" taxes (*i.e.*, taxes owed directly by the corporation and not withheld or collected from third parties).

These two cases involve corporations in Chapter 11 bankruptcy reorganizations. Each corporation owes the government both trust fund and ordinary (non-trust fund) taxes. In each instance, the reorganization plan says that the corporation must satisfy its total tax debt to the

* Of the District of Massachusetts, sitting by designation.

government by making partial payments each year for several years. In each instance, the bankruptcy judge specified that, as the reorganized corporation paid off its tax debts, the government should treat the payments as satisfying the corporation's *trust fund tax* debts *first*; only after it received enough money to satisfy all trust fund debts may the government apply the money received to the corporation's non-trust fund tax debts. This order of payment helps the "responsible" individuals associated with the corporation, for it diminishes the likelihood that they will end up having *personally* to pay the "trust fund" tax debts that the corporation owes. That fact also means that the government may find it harder to collect the *entire* tax debt (trust fund and non-trust fund). If, for example, the reorganized corporation were to run out of money a few years from now and "trust fund" debts were still owed, the government might collect them from "responsible" individuals. But, if all "trust fund" debts have been paid, and if the only debts are for, say, ordinary corporate income taxes, the government will be out of luck, for there are no *personal* guarantors of payment of a corporation's ordinary tax liabilities.

The IRS has appealed these two bankruptcy court decisions. It wants to apply the debtors' payments to the ordinary, non-trust fund, tax debts first. It argues that it is entitled to do so because payments pursuant to a Chapter 11 reorganization plan are "*involuntary*" payments; and under a longstanding IRS policy, backed by case-law authority, the IRS may designate the allocation of "involuntary" payments among a firm's various tax debts as the IRS sees fit. The IRS adds that to allocate Chapter 11 tax payments to "trust fund" tax debts will frustrate the congressional policy underlying Section 6672 of the Internal Revenue Code, 26 U.S.C. § 6672 (1982), which holds "responsible" individuals personally liable for a corpora-

tion's "trust fund" tax debts. In *Energy Resources*, the district court rejected these arguments and affirmed the bankruptcy court's allocation of payments to "trust fund" debts first; in *Newport Offshore* the district court accepted these arguments and reversed the bankruptcy court's order for payment of "trust fund" tax debts first.

The basic legal question that these two cases raise on appeal is whether the bankruptcy court has the legal authority to order the government to apply the tax payments made by the reorganized corporation to the corporation "trust fund" debts first. We conclude that the bankruptcy court does possess that legal power, regardless of whether the payments are characterized as "voluntary" or "involuntary." Our result is consistent with that of the Eleventh Circuit in *In re A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, ___ U.S. ___, 108 S. Ct. 1724 (1988). Our result is not consistent with that reached by the Third Circuit, in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987) (tax payments made pursuant to a Chapter 11 reorganization are *per se* "involuntary" and "no provision of the Bankruptcy Code allows either the debtor or the bankruptcy court to direct" the allocation of such payments). Two other circuits have followed the Third Circuit. *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988) (per curiam); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987).

I. Background

The first case before us concerns a Chapter 11 debtor called Newport Offshore, Inc. Newport Offshore failed to pay the government employee social security and unemployment withholding taxes ("trust fund" taxes) in 1985; it owes the government some ordinary, non-trust fund,

taxes as well. On November 13, 1985, Newport Offshore filed a petition for reorganization under Chapter 11 of the Bankruptcy Act, 11 U.S.C. §§ 101-1330 (1982). In June 1986, the bankruptcy court appointed a trustee to run Newport Offshore's business. *See* 11 U.S.C. § 1104 (1982 & Supp. IV 1986). Subsequently, Allied Marine Associates, a Rhode Island partnership, agreed to pay all Newport Offshore's prepetition tax liability, to pay various other debts, and to invest additional money in the corporation; in return, it would receive 85 percent of the shares of the new, reorganized Newport Offshore. The reorganization plan provided that the reorganized Newport Offshore would pay its tax debts (totalling about $300,000) over a period of about six years and that the money would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the tax debts owed. The IRS objected to the plan's tax debt payment designation provision. The bankruptcy judge, after hearing IRS's objections, approved the plan. The IRS appealed to the district court, which reversed, following the Third Circuit in *Ribs-R-Us, supra.* The debtor now appeals that decision here.

The second case involves a debtor called Energy Resources Co., Inc. In January 1983, the debtor petitioned for reorganization under Chapter 11. In September 1984 the Bankruptcy court confirmed a reorganization plan under which all of Energy Resources' assets, except those of its Environmental Division, would be placed in a special trust (called the ERCO Liquidation Trust) to pay debts owed, including about $1,000,000 in federal taxes, most of which were trust fund taxes. The ERCO Liquidation Trust was to pay the tax debt over a period of about five years. The plan also provided that reorganized Energy Resources, Inc. would, upon merging with an independent company, continue to operate under the name Enseco,

Inc. In November 1985 the trustee of ERCO Liquidation Trust sent checks to the IRS for about $280,000, which represented the scheduled payment and $78,000 in additional payments. The trustee asked the IRS to apply the money to Energy Resources' "trust fund" tax debt. The IRS refused to accept the trustee's designation. The trustee then asked the bankruptcy court to order the IRS to apply the money to the "trust fund" tax liabilities. After hearing argument, the bankruptcy court held that tax payments made pursuant to a Chapter 11 reorganization are "voluntary" payments, and it "ordered" the IRS "to apply tax payments under the Plan as designated by the Trustee." The IRS appealed this order to the District Court, which affirmed the bankruptcy court. The IRS now appeals that decision.

II. The Law

In our view, these cases require us to answer *two* legal questions. The first legal question concerns the scope of IRS policy. It is whether a payment made pursuant to a Chapter 11 reorganization plan is "voluntary" or "involuntary," as IRS rules and regulations use these terms. Our answer to that question is similar to that of the Third Circuit. We believe that the law permits the IRS to call tax payments within a Chapter 11 reorganization "involuntary," for purposes of applying its own regulations. We reach a result that differs from the Third Circuit, however, because we believe we must ask a second question: Does the law permit a bankruptcy court to order the IRS to allocate an "involuntarily" made payment to a debtor's "trust fund" tax liability first? We conclude that the law does authorize a bankruptcy court to order the IRS to allocate such "involuntary" payments to a taxpayer's "trust fund" liability first, provided that the court reasonably

concludes that this allocation will likely increase the reorganization plan's chances for success. We shall analyze each of these two legal questions in turn.

A. The "IRS Rule" Question: "Voluntary" or "Involuntary"?

IRS policy has long permitted a taxpayer who "*voluntarily*" submits a payment to the IRS to designate the tax liability (*i.e.*, "trust fund" or non-trust fund tax debts) to which the payment will apply. *See* Rev. Rul. 79-284, 1979-2 C.B. 83, *modifying* Rev. Rul. 73-305, 1973-2 C.B. 43, *superseding* Rev. Rul. 58-239, 1958-1 C.B. 94 ("partial payments of . . . tax[es] are to be applied as the taxpayer designates . . . where the taxpayer provides specific written instruction for the application of a voluntary partial payments"); *Slodov*, 436 U.S. at 252 n.15. *In re Technical Knockout Graphics, Inc.*, 833 F.2d at 801; *In re Ribs-R-Us, Inc.*, 828 F.2d at 201; *In re A & B Heating & Air Conditioning*, 823 F.2d at 436; *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *see also Wood* v. *United States*, 808 F.2d 411, 416 (5th Cir. 1987). However, where the taxpayer "*involuntarily*" makes the payment, the IRS has granted the taxpayer no such freedom to designate the allocation; the IRS will decide to apply the payment; and it will almost always decide to apply the payments to a non-trust fund tax debt first. *See* IRS Policy Statement P-5-60, *reprinted in* 1 Administration, Internal Revenue Manual (CCH) 1305-15; *Slodov, 436 U.S. at 252 n.15; In re Technical Knockout Graphics, Inc.*, 833 F.2d at 801; *In re Ribs-R-Us, Inc.*, 828 F.2d at 201; *In re A & B Heating & Air Conditioning*, 823 F.2d at 436; *Muntwyler*, 703 F.2d at 1032.

These payment designation rules, says the IRS, are consistent with "the common law" policy,

> generally recognized between creditors and debtors, that the debtor may indicate which debt he intends to

> pay when he voluntarily submits a payment to his creditor, but may not dictate the application of funds that the creditor collects from him.

In re Energy Resources Co., Inc., Brief for Appellants [IRS], at 18 n.11. *See O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *see also Hewitt* v. *United States*, 377 F.2d 921, 925 (5th Cir. 1966). The IRS adds that the Tax Court defined the "voluntary"/"involuntary" distinction authoritatively in *Amos* v. *Commissioner*, 47 T.C. 65 (1966), where it said,

> [a]n involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

Amos, 47 T.C. at 69. *But see also Muntwyler*, 703 F.2d at 1033 ("The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money, as in a levy." (emphasis in the original).

The IRS argues that payments made by compromise pursuant to a Chapter 11 reorganization plan fall within the (rearranged) literal words of *Amos* ("payment received as a result of a legal proceeding in which the government is seeking to file a claim for its delinquent taxes"); it sees a payment made pursuant to a Chapter 11 plan as a payment made pursuant to a court order; and it distinguishes *Muntwyler* on the ground that the trustee there did not act pursuant to a *court* order, or a bankruptcy proceeding, thus taking the case outside the scope of *Amos*'s words "legal proceeding."

In essence, the IRS sees the words "voluntary" and "involuntary" as defining polar opposite points on a spectrum. At the "voluntary" end, one finds the taxpayer who discharges a debt *before* the IRS brings a legal proceeding against him. At the "involuntary" end, one finds the taxpayer whose property the court has seized and transmitted to the IRS. The IRS believes that the court's control of the taxpayer's assets in a Chapter 11 proceeding, along with the court's power to confirm the plan, bring this case close enough to the "involuntary" end of the spectrum to warrant the finding that all payments made pursuant to a Chapter 11 reorganization plan are "involuntary."

The debtor corporations, Energy Resources Co. and Newport Offshore, Ltd., counter that *Muntwyler's* phrase "resulting in an actual *seizure*" applies to court action as well as to administrative action, and that the "limited role of the court in confirming [a reorganization] plan demonstrate[s] that the action of a Chapter 11 court falls far short of the coercive power of a levy, execution or judicial sale." *In re Energy Resources*, Brief for Appellee, at 12. Therefore, they conclude, tax payments made subject to a Chapter 11 reorganization plan are not "involuntary" tax payments.

The bankruptcy courts have split over the question of whether tax payments made pursuant to Chapter 11 reorganizations are "voluntary" or "involuntary." *See* cases collected in *In re A & B Heating & Air Conditioning*, 823 F.2d at 463 n.2. As we pointed out above, at p. 6, *supra*, the circuit courts have also divided on the question. In *re Ribs-R-Us, Inc., supra*, the Third Circuit concluded that such payments are "most realistically classified as involuntary for purposes of the debtor's ability to designate to which taxes the payments should be allocated." *Rib-R-Us*, 828 F.2d at 203. The Ninth and Sixth Circuit have followed the Third Circuit's *Ribs-R-Us* reasoning. *See In re*

Technical Knockout Graphics, Inc., supra; *In re DuCharmes & Co., supra*. The Eleventh Circuit, however, in *In re A & B Heating & Air Conditioning, supra,* held that payments made pursuant to a Chapter 11 reorganization plan, at least sometimes, are "voluntary."

In our view, the labeling question is a difficult one because a Chapter 11 proceeding has *some* characteristics that make one consider a related tax payment "involuntary," but it also has *other* characteristics that make a "voluntary" label seem more natural. The Third Circuit, in *Ribs-R-Us,* 828 F.2d at 202-03, has pointed to those features of a Chapter 11 proceeding that make the payment seem "involuntary:" (1) Once a debtor files for reorganization under Chapter 11 all its assets vest in the bankruptcy estate, 11 U.S.C. § 541 (1982 & Supp. IV 1986). (2) The debtor-in-possession (or other trustee) is no longer free to spend the debtor's money; rather, he must act as a "fiduciary" for the benefit of the creditor, 11 U.S.C. § 1107 (1982 & Supp. IV 1986); *see Wolf* v. *Weinstein*, 372 U.S. 633, 649-50 (1963), and, he must act in accordance with orders the bankruptcy court may issue, 11 U.S.C. §§ 105(a); 1141(a), 1142(b) (1982 & Supp. IV 1986). (3) The bankruptcy court will determine the effect of the debtor's tax liability, 11 U.S.C. § 505 (1982 & Supp. IV 1986). (4) The debtor *must* produce a plan that will see that all tax claims (those enjoying what is now called a "seventh priority," 11 U.S.C. § 507(a)(7) (Supp. IV 1986)) are paid in full "over a period not exceeding six years after the date of assessment of such claim[s]," 11 U.S.C. § 1129(a)(9)(C) (Supp. IV 1986). (5) A bankruptcy court order confirming a plan is an order requiring the debtor (or trustee) to carry out the plan, 11 U.S.C. § 1142 (Supp. IV 1986), including, of course, its payment schedule. (6) If the debtor fails to produce, or comply, with such a plan, the bankruptcy court may convert the proceeding, against

the debtor's wishes, into a Chapter 7 liquidation, 11 U.S.C. 1112(b) (1982 & Supp. IV 1986), which invariably will involve a bankruptcy court order requiring the debtor (or the trustee), to pay assets to the government to satisfy tax liabilities.

On the other hand, a Chapter 11 proceeding also has important features that favor application of a "voluntary" label. They include the following: (1) The debtor may choose "voluntarily" to enter a Chapter 11 reorganization proceeding (2) The Chapter 11 proceeding offers the taxpayer *protection* from creditors, *including the IRS*; the debtor need not pay its tax debts for six years, 11 U.S.C. § 1129(a)(9)(C), and, as a practical matter, given that six year leeway, it may take the IRS longer to get its money from such a taxpayer than from delinquent taxpayers who are not in bankruptcy, against whom the IRS can demand immediate payment and pursue such legal action as a obtaining a levy on the debtor's property. (3) Chapter 11 gives the debtor many "options" for structuring payment and considerable "latitude" as to "how and when the IRS will be paid." *In re Lifescape, Inc.*, 54 B.R. 526, 528 (Bankr. D.Colo. 1985). (4) Here, third parties (Allied Marines in *Newport* and Enseco in *In re Energy Resources*) provided the money (or much of the money) used to pay the IRS; no law nor any court order *required* these third parties to provide their money. Moreover, the bankruptcy judge in *Newport* wrote that this feature of these cases is not unusual. He said "in the real world of business reorganizations, most successful Chapter 11 plans depend, in part, at least, on the infusion of funds provided by outside investors." (5) If a debtor fails to produce an acceptable Chapter 11 plan, the bankruptcy court need not convert the proceeding into a Chapter 7 liquidation; the court may decide simply to dismiss the proceeding, 11 U.S.C. § 1112(b), leaving the debtor back

where he started; (6) Under historic bankruptcy practice, a debtor can propose *which* of a creditor's several debts a particular payment shall satisfy. *See National Bank of the Commonwealth* v. *Mechanics' National Bank*, 94 U.S. 437, 439 (1876) ("The rule settled by this court as to the application of payment is, that the debtor or party paying the money may, if he chooses to do so, direct its appropriation.") And, this practice is important considering the IRS suggestion that its "voluntary"/involuntary" rule basically mimics ordinary debtor/creditor law. *See* p. 11, *supra*.

Given the strength of both sets of competing considerations, we are not surprised to find a split in the circuits. We recognize, however, that when we evaluate these considerations, we must pay particular attention to an interpretation that a government agency offers of *its own rules and regulations*. *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 565-66 (1980); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-14 (1945); *LaFlower* v. *United States*, 849 F.2d 8, 12 (1st Cir. 1988); *United States* v. *Franchi-Forlando*, 838 F.2d 585, 588 (1st Cir. 1988). Despite the strength of the arguments favoring a determination that these payments are voluntary, we cannot say that the IRS's view is *clearly* unreasonable. We therefore accept its view that payments made pursuant to a Chapter 11 plan are "involuntary" for purposes of its own rules. That conclusion only means, however, that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue. *See Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Railway Co.*, 284 U.S. 370, 389-90 (1932) (an agency must follow its own rules).

B. The Bankruptcy Court's Power to Allocate Tax Payments

A central legal question remains: Does a bankruptcy court possess the legal power to order the IRS to apply a

payment in a way that runs *counter* to IRS's own internal policies? That is to say, may a bankruptcy court order the IRS to apply an "involuntary" payment made by a Chapter 11 debtor to "trust fund" tax liabilities first, and only later apply payments to ordinary, non-trust fund tax liabilities? *Compare In re A & B Heating & Air Conditioning*, 823 F.2d at 464 (noting tension between Internal Revenue Code's aim to "maximize the public fisc" and the Bankruptcy Code's "preference toward reorganization rather than liquidation"). We conclude that the answer to this question is "yes," for several reasons.

First, Congress has granted bankruptcy courts broad equitable powers, including those powers "expressly or by necessary implication conferred by Congress." *Johnson* v. *First National Bank of Montevideo*, 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 104 S. Ct. 1015 (1984); *see also Pepper* v. *Litton*, 308 U.S. 295, 304-05 ("The bankruptcy courts have exercised these equitable powers in passing on a wide variety of problems arising out of the administration of bankrupt estates."); *In re Leasing Consultants, Inc.*, 592 F.2d 103, 107 (2d Cir. 1978) (bankruptcy court sits in equity); 11 U.S.C. § 1129(b)(1) (court must ensure that reorganization plan is "fair and equitable"). And historically, bankruptcy courts have been called upon to use their powers to promote the "twofold" (and often conflicting) purpose of the Bankruptcy Code: ensure fair payment to creditors *and* provide the bankrupt firm with an opportunity to make a "fresh start." *Burlington* v. *Crouse*, 228 U.S. 459 (1913). The bankruptcy court may "issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions" of the Bankruptcy Code. 11 U.S.C. § 105 (emphasis added). At least on some occasions, an order allocating Chapter 11 tax payments to "trust fund" liabilities first would seem "appropriate." Suppose, for example, that certain third parties that included "responsible" individuals were willing to advance

enough money to rehabilitate the corporation only if the court would assure them that the reorganized corporation would pay its "trust fund" tax debts first. That assurance would diminish the likelihood that the third parties would have to pay the debts personally; without it they might prefer immediate liquidation, which could mean total payment of all tax debt, and "a guarantee[] that no tax penalty will be assessed against them personally." Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 Minn. L. Rev. 1279, 1299-1300 (1986). Of course, to give the "responsible" persons this assurance, and then allow the reorganized corporation to stretch out its tax payments over six years, might diminish the chances that the reorganizing firm will pay its *entire* tax debt, for no one can be absolutely certain that the reorganized corporation will still have money four or five years into the future. But, by giving this assurance, and thereby keeping the firm alive, the bankruptcy court would also increase the chances that the debtor will pay something to its general unsecured creditors. As the Eleventh Circuit pointed out, "[f]requently, the efforts put forth by these officers during the reorganization is the corporation's only hope for future viability." *In re Heating & Air Conditioning*, 823 F.2d at 465.

Second, bankruptcy courts have long had the legal power to tell creditors against which of a debtor's several debts they are to apply a particular payment; *see National Bank of the Commonwealth*, 94 U.S. at 439; *see also* 60 Am. Jur. 2d [*Payment*] § 103 (1987) ("A court applies involuntary payments according to principles of equity and justice, according to intrinsic justice or the equity of the case, according to rights and priorities concerned, or ratably to all debts, and in such a way as will best maintain and protect the rights of all the parties.") (citations omitted). There is case law authority holding that courts may order the IRS to ignore its own "allocation" rules. *See*

Commercial Credit Corporation v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D. Ark. 1955) (federal district court exercised its equitable powers to set aside IRS allocation of involuntary payment because allocation was unfair to other creditors); *cf. Amos* v. *Commissioner*, 47 T.C. 65, 70 n.5 (1966) ("We expressly refrain from deciding whether the same right of application governs where the rights of other creditors may be adversely affected."). And, to the extent that courts have held to the contrary, they have simply assumed that the IRS's internal "voluntary"/"involuntary" categorization determined the matter without considering whether a bankruptcy court held the legal power to allocate tax payments over the IRS's objection. See cases cited at p. 11, *supra*.

Third, nothing in the bankruptcy statute limits, in any relevant way, the bankruptcy court's power to allocate when the creditor is the IRS. To the contrary, Congress specifically granted the bankruptcy court the power to restucture tax debts, along with other debts, insisting, only by way of compromise, that a Chapter 11 plan must ensure that the debtor will pay all tax debts *within six years* (from the date of assessment.) We must read the absence of such restrictions in light of Congress' specific regulation of the compromise nature of Chapter 11's tax debt policy. The Senate wrote:

> In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.
>
> . . .
>
> A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumu-

> lation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.

S. Rep. No. 989, 95th Cong., 2d Sess. 13-14, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5799-800. We cannot assume that Congress automatically preferred the resolution of all such tension (illustrated by the issue before us) in favor of the IRS.

Fourth, it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of Chapter 11 tax payments. It is unlikely that the IRS, charged with the duty to collect taxes rather than to worry about firms in bankruptcy, could easily balance on a case-by-case basis the increased "tax collection" risk against the increased likelihood of "rehabilitation." But, it is very likely that the bankruptcy court could and would do so; indeed, it is just this kind of work that it ordinarily performs. Of course, the statute requires the bankruptcy court to assure itself that reoganization will succeed, 11 U.S.C. § 1129(a)(11) (1982), and that therefore, the IRS, in all likelihood, will collect the *total* tax debt owed; and that court has no more than a six year leeway within which to structure payments. 11 U.S.C. § 1129(a)(9)(C). But, acting *within* that leeway, it would seem to make administrative sense to permit the court to structure not only times and amounts of payment, but also the particular tax debt to which each payment shall be allocated.

Fifth, the IRS's policy of allocating payments first to a corporate debtor's non-trust fund tax liability is not a statutory policy. That policy, created by internal rule, is designed to preserve the liability of the "responsible" individuals. It thereby increases the likelihood that the IRS will ultimately collect the *entire* tax debt ("trust fund" and non-trust fund) owed by the corporation. This objection is understandable, even commendable, for an agency whose mission is to *collect taxes*. *See* Rev. Rul. 79-284, 1979-2 C.B. 83, *modifying* Rev. Rul. 73-305, 1973-2 C.B. 43, *superseding* Rev. Rul. 58-239, 1958-1 C.B. 94 ("[T]he Internal Revenue Service will allocate partial payments of withheld employment taxes . . . *in a manner serving [the IRS'] best interests.*") (emphasis added). But, we can find no *statute* that attaches so overriding an importance to this tax objective as to circumscribe a court's statutorily granted powers to the contrary. As a general matter, the IRS cannot, in any obvious way, circumscribe, by using an internal rule, a court's statutory powers. *See Dixon* v. *United States*, 381 U.S. 68, 74 (1965).

Sixth, we can find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here. The IRS argues strongly that requiring the IRS to allocate tax payments in Chapter 11 proceedings to "trust fund" debts first would frustrate the congressional intent of 11 U.S.C. § 6672—the statute that permits the IRS to collect unpaid "trust fund" taxes directly from the personal assets of "responsible" individuals. But, we do not see how that is so.

We agree with the IRS that Section 6672 reflects a strong congressional policy to collect "trust fund" tax liabilities. Such a policy reflects the fact that if a corporation is unable to pay its "trust fund" taxes, the United States Treasury suffers the loss because the employees from whose wages the taxes are withheld are still credited with those amounts as if they had in fact been paid to the government. *United States* v. *Huckabee Auto Co.*, 783

F.2d 1546, 1548 (11th Cir. 1986); *In re Avildsen Tools & Machine, Inc.*, 794 F.2d 1248, 1251 n.6 (7th Cir. 1986). But, we do not agree that such a policy helps the IRS in its argument. Indeed, the IRS's argument seems to stand the policy of Section 6672 on its head: The IRS's Chapter 11 allocation policy and interpretation of Section 6672 does not assure that "trust fund" taxes are promptly turned over to the government. Rather, it ensures that "trust fund" money is paid over *last*, only after all non-trust fund taxes have been paid.

The IRS seeks to use the personal liability of "responsible" persons, not to help collect "trust fund" tax debts, but to collect *total* tax debts. And, in order to help maximize that total collection, it is willing, by not crediting the "trust fund" debt first, to run a greater risk of *not* collecting the 'trust fund" debt at all, as would be the case if the reorganized corporation ran out of money while paying the non-trust fund tax debt and there were no personal assets of "responsible" persons. In this way, the IRS's allocation policy gives ordinary, *non*-trust fund tax debts a special status; it places the payment of "trust fund" tax debts at risk; and it effectively forces the "responsible" persons to be liable for the *last* tax dollars due from the debtor, a liability which Congress did not say "responsible" persons ought to have. Section 6672 does refer to "responsible" person liability as a "penalty" but this characterization "does not alter their essential character as taxes." *United States* v. *Sotelo*, 436 U.S. 268, 275 (1978); *Huckabee Auto Co.*, 783 F.2d at 1548 ("Although denoted a penalty in the statute, the liability imposed by section 6672 is not penal in nature, but is 'simply a means of ensuring that the tax is paid.' ") (quoting *Botta* v. *Scanlon*, 314 F.2d 392, 393 (2d Cir. 1963)) (citation omitted). And, the IRS collects the amount of the unpaid trust fund taxes *only once*, from the

"responsible" individuals, the corporate debtor, or some combination thereof. *Sotelo*, 436 U.S. at 279 n.12; *USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d 1238, 1243 & n.7 (5th Cir. 1986) (citing IRS Policy Statement P-5-60, *supra*). Indeed, the IRS itself has said that it would try to collect trust fund taxes from responsible individuals " 'only when all other means of securing the delinquent taxes have been exhausted.' " *Sotelo*, 436 U.S. at 279-280 (quoting Opinion B-137762 (May 3, 1977), *reprinted in* CCH 1977 Stand. Fed. Tax Rep. ¶ 6614, at 71,438 (statement of Comptroller General of United States)).

A simple example will help illustrate our problem with the IRS argument. Assume, for example, that a debtor owes the IRS $1 million in "trust fund" tax liabilities and $5 million in ordinary, non-trust fund tax liabilities. Assume further that the Chapter 11 reorganization plan schedules payments of $1 million per year for six years. Although the bankruptcy court will not approve such a schedule unless it is convinced that the debtor will pay the entire $6 million over the six years, we can understand the IRS's fear that risk of noncollection for later payments is greater than for earlier payments. We cannot, however, understand the IRS's argument that a bankruptcy court's insistence that the IRS apply the first $1 million payment to "*trust fund*" debts inhibits its collection of such debts. Such an allocation does indeed tend to prevent the IRS from pursuing "responsible" individuals for the money after Year One (or if the IRS has pursued them, they can obtain a refund, 26 U.S.C. § 6511(a) (1982)); but that is only because the *"trust fund" debts have been paid.* If the IRS were anxious simply to check off the tax liabilities in its "trust fund" books, it would as we have said, try to get this money in Year One, not Year Six (by which time the risk increases that both debtor corporation and "responsible" individuals will lack the assets to pay.)

In fact, because money is fungible, the effect of the bankruptcy court's ruling is to diminish the IRS's ability (by looking to "guarantors" of the "trust fund" $1 million) to obtain the *whole* six million. But, that ruling releases the guarantor only to the extent that the IRS *actually receives* $1 million, the full "trust fund" liability; and as to the remaining $5 million, the IRS is no worse off than had the *entire debt* been an ordinary tax debt without a "trust fund" component. And, so long as there is a "trust fund" tax debt outstanding, nothing, including our opinion today, legally restrains the IRS from attempting to collect "trust fund" taxes from "responsible" individuals. *See In re LaSalle Rolling Mills*, 832 F.2d 390 (7th Cir. 1987) (Anti-injunction Act prohibits courts from restraining IRS from collecting "trust fund" taxes from individuals under § 6672); *A to Z Welding & Manufacturing, Co.* v. *United States*, 803 F.2d 932 (8th Cir. 1984) (same); *Huckabee Auto Co., supra.*

As we have said, we can find no policy in any statute suggesting that Congress felt that bankruptcy courts must maximize the likelihood that the IRS will receive its entire tax debt, irrespective of all other goals, particularly the Bankruptcy Code's preference for rehabilitation over liquidation. We note that a bill introduced in the House of Representatives would give the IRS the very statutory power it seeks here. *See* H. R. 3984, 100th Cong., 2d Sess. § 201 (1988) (proposing that Section 505 of title 11 of the United States Code be amended to include that "[p]ayments of taxes under this title to a governmental unit may be applied by the governmental unit in a manner that preserves alternative sources of collection, if any"). But, Congress has not enacted that bill into law.

Thus, in weighing the competing aims of the Bankruptcy Code and Internal Revenue Code, we reach the same result as the Eleventh Circuit in *In re A & B Heating*

& Air Conditioning, supra. We hold that " 'the allocation question in a Chapter 11 case under the Bankruptcy Code should be left to judicial discretion to be decided on a case-by-case basis.' " *Id.* at 465 (quoting *In re B & P Enterprises, Inc.*, 67 B.R. 179, 183 (Bankr. W.D.Tenn. 1986)). Specifically, the bankruptcy court should make the following inquiry: upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money? And, the standard for judging the lawfulness of any such bankruptcy court action should be similar to that applied to other bankruptcy court tax-related actions. *See e.g., Darman* v. *Metropolitan Alarm Corp.*, 528 F.2d 908 (1st Cir. 1976) (findings of fact by bankruptcy judge entitled to stand unless "clearly erroneous"). In applying this test, of course, the bankruptcy court must recognize the obvious importance of satisfying tax liabilities, but where this test is satisfied, we are convinced that the bankruptcy court has the legal power to order the allocation.

IV. The Result

We have also considered whether or not we we must remand these cases to the bankruptcy court for reconsideration in light of the appropriate standard. We should do so if these courts ordered the "trust fund" debt paid first *simply because* they thought the IRS rules so required, *i.e.*, if they did so simply because they thought these payments were "voluntary," and if they might have exercised their legal authority differently had they realized that their allocation orders ran contrary to IRS policy. Having

examined the opinions of the bankruptcy courts and the records in these cases, we conclude that no remand is necessary.

The bankruptcy judges in both cases clearly understood the IRS's opposition to their "trust fund" allocation orders. The bankruptcy judge in *Newport Offshore* considered that he had the legal "flexibility" to allocate payments to "trust fund" tax debt when bankruptcy related circumstances so required. He wrote that he considered the "totality of the circumstances," he noted the special circumstances that a "third party, Allied Marine Associates," provided funding for the plan, and he rejected as without "factual or practical support" the IRS claim that the allocation would do no more than benefit a particular individual who was a "responsible" person. Moreover, given the presence of the third party, the record offers adequate support for the reasonableness of a determination that the allocation order is both fair and will help to rehabilitate the company. Under these circumstances, we do not believe that remanding could serve any purpose.

The bankruptcy court opinion in *In re Energy Resources* indicates less clearly that the court would reach the same conclusion had it been aware of our eventual conclusion about the law. The court seemed to base its result upon its "voluntary" versus "involuntary" analysis. Nonetheless, that court held a special hearing about whether it should order the IRS to accept the taxpayer's payment designation, it heard argument about the trustee's claim that the designation would not significantly hurt the IRS, and that it was "necessary" for the trustee to maximize the extent to which the IRS payments would "benefit the estate." In addition, the bankruptcy judge found that "the Plan in the instant case and the tax payments at issue were made possible, at least in part, by the infusion of capital" from a third party. And, in issuing the order it specifically rested

its decision upon the "entire record of the case and the arguments of counsel." The record makes us reasonably certain that the court would not have reached a different result had it been fully aware that it was ordering the IRS to accept a designation contrary to IRS rules. And, the record provides adequate support for the court's conclusion.

For these reasons, we conclude that the orders of the bankruptcy judges in both cases are lawful. Therefore, the judgment of the district court in *In re Newport Offshore Ltd.* is

Reversed.

The judgment of the district court in *In re Energy Resources Co.* is

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

Civil Action No. 86-1533Mc

IN RE ENERGY RESOURCES CO., INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

ENERGY RESOURCES, CO., INC., APPELLEE

August 5, 1987

Memorandum and Order

MC NAUGHT, D.J.

The issue presented by this appeal was whether the bankruptcy court erred in holding that the payments of tax pursuant to a Chapter 11 Plan were voluntary, and therefore, their application could be directed by the Trustee. *Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir., 1983). If payments are "involuntary", the Trustee may not direct the application of the payments.

On April 7, 1986 the Bankruptcy Court entered an Order allowing the motion of the Liquidation Trustee, and ordering the Internal Revenue Service to apply tax payments under a confirmed Plan, as designated by the Trustee. The terms of the Plan approved by the Bankruptcy Court provide that the taxing authorities are to be paid in full with interest in four equal payments commencing one year after the confirmation date of the Plan. During the year 1985, the Trustee tendered one check in the

amount of $203,516.54, and another in the amount of $78,000, the Trustee designating to the IRS that these payments be applied first to the trust fund portions of taxes due from the debtor. The IRS refused to accept the checks under the terms of the designation, without a court order. The Bankruptcy Judge, as recited hereinbefore, granted a motion for such an order, and this appeal followed.

The basic principle, as enunciated in *Muntwyler*, supra, is that if a taxpayer's payment is "voluntary", the taxpayer may designate its allocation among tax, penalty and interest. If it is "involuntary", the taxpayer, here the Trustee, may not designate. Bankruptcy Judge James Gabriel held that the payments were voluntary, by reason of broad discretion given to debtors under § 1129 of the Bankruptcy Code. 11 U.S.C. § 1129(a)(9)(C). I agree with the conclusion of the Bankruptcy Judge that Section 1129 payments are voluntary, and that this ruling is consistent with the policies underlying Chapter 11.

The United States contends on this appeal that, since "court action" is involved in a Chapter 11 proceeding, Section 1129 payments are therefore "involuntary".

The argument of the Trustee (to the effect that the payments are voluntary) is perhaps best summed up in *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985) in the following language: "The mere filing of a claim in a Chapter 11 proceeding is clearly not the type of court action envisioned in *Amos* and *Muntwyler* since it does not approach the 'actual seizure of money or property as in a levy'. . . . The fact that payments are made pursuant to a plan which must comply with the requirements of the Bankruptcy Code does not rise to a level of court action equivalent to a levy, judicial order, execution or judicial sale."

The reason behind the statement of the principle is the recognition by courts that Section 1129 allows "far greater flexibility" than was available under the Bankruptcy Act.

Along with the Trustee and the Judge in Bankruptcy, I see a distinction between the court's role in confirming a plan under Section 1129 and other court action, rising to the level of a seizure. It seems to me that the position of the appellant fails to recognize that the action of the Bankruptcy Court in this voluntary Chapter 11 reorganization is limited action: the approval of a plan designed by the debtor within the flexible parameters of Section 1129. The court here didn't compel action; rather, it approved a payment which a debtor wished to make.

Judge Gabriel's reliance upon decisions such as *In re A&B Heating and Air Conditioning Inc.*, 53 B.R. 54 (Bankr.M.D. Fla 1985), aff'd May 7, 1986) and *In re Lifescape, Inc.*, 54 B.R.526 (Bankr. D. Colo. 1985) is well placed.

The Order of the Bankruptcy Court is affirmed. The Internal Revenue Service is directed to apply the tax payments in accordance with the designation of the taxpayer.

/s/ JOHN MC NAUGHT
John J. Naught
United States District Judge

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF RHODE ISLAND

Docket Number CA 87-0433

UNITED STATES OF AMERICA

vs.

NEWPORT OFFSHORE, LTD.

Providence, Rhode Island
December 9, 1987

TRANSCRIPT OF PROCEEDINGS IN ABOVE-CAPTIONED CASE BEFORE CHIEF JUDGE FRANCIS J. BOYLE.

[35] THE COURT: This is an appeal from the confirmation of a plan by the Bankruptcy Judge in this district in the matter of in re Newport Offshore LCD debtor Bankruptcy Number 885723. The Bankruptcy Judge's opinion appears at 75 Bankruptcy Reporter 919 and was filed on July 14 of 1987. The plan in part provides how the tax payments, federal tax payments, should be [36] applied. Specifically the plan provides that payments be credited first to the trust fund portion of the oldest taxes. Second, to the interest on such trust fund portion of such taxes, and, third, to the oldest nontrust fund portion of the remaining tax obligations and the interests thereon.

The Interest Revenue Service objects to the application of the tax payments as proposed and argues that it be permitted to apply the tax payments first to the nontrust fund taxes in accordance with IRS policy. The significance of this is that under the provisions of 26 United States Code Section 6672 any person required to collect, truthfully

account for and pay over any tax imposed by the title is subject to personal liability if the taxes are not paid giving Internal Revenue Service something similar to two strings to its bow. That is, it may collect the taxes from the corporation or it may collect the taxes from the person involved in the corporation who has the ability to direct the payment and application of the corporation's income and assets.

The fact of the matter is that with respect to [trust] fund taxes, particularly withholding taxes and social security taxes which are withheld by the employer and not paid over to the government, the government is [37] required to credit the employee with the payment of those taxes in spite of the fact that the government does not receive those taxes. The theory of Section 6672 is that the assets of the corporation have been misapplied by the persons who had control over them in terms of not carrying out the trust which is imposed with respect to those type of taxes.

There is a thorough and complete split in the Circuits with respect to whether or not under these circumstances of this plan payments to the Internal Revenue Service are voluntary or involuntary. That split is dependent on the application of a definition of what is voluntary and what is not voluntary contained, which is contained in the Amos case. Amos versus The Commissioner, a Tax Court decision in 1966 which says that an involuntary payment of federal taxes means any payment received by agents of the United States as the result of the restraint or levy or from a legal proceeding in which the government is seeking to collect its delinquent taxes or file a claim therefor. Amos was obviously not a bankruptcy case, it's a case cited in the Tax Court. And the definition perfectly serves the purposes for which it was given. It has, however, been applied by I think the Eleventh Circuit as being the only definition, and in this instance by the Bankruptcy [38] Judge as being the

only definition of what is involuntary. The definition does not take into consideration the nature of the bankruptcy proceeding, whether a voluntary petition or not. The Bankruptcy Court takes control of the debtor's assets and which thereafter administers those assets for the benefit of all of the creditors, including Internal Revenue Service. That Internal Revenue Service is not in the position at that point in time to engage in any kind of restraint or levy or bring a legal proceeding, except file a claim in the bankruptcy proceeding and to seek relief in the Bankruptcy Court. So that it seems to me adopting the definition of Amos is to create a strawman argument here that under which the government, the Internal Revenue Service cannot possibly succeed, that by defining "involuntary" in the way that it is done it excludes bankruptcy proceedings. I don't think that's what Internal Revenue Service's policy means or how it intends to apply it. Nor do I think the Congress had that result in mind.

I'm satisfied that the better reasoning, the more complete reasoning, the more sensible reasoning is that found in the Third Circuit's more recent opinion in the matter of Ribs Are Us Incorporated in which the United States was an appellant, an opinion filed by [39] a panel of the Third Circuit on September 9, 1987, subsequent to the Bankruptcy Judge's opinion. That opinion I would incorporate in full in mine. It seems to me that it adequately argues the various points of view that have arisen with respect to this question and I believe comes down on the better side of the argument that the Congress would see to it that both of these policies work together, the policy of reorganization and the policy of collecting taxes and avoiding what is not just a loss of taxes but a double-whammy to the government in terms of these trust fund taxes, that Congress, if asked the question, would say "we did not ever intend that a principal stockholder of a cor-

poration in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes, that both of these policies can coexist and should be applied coextensively." Under these circumstances, therefore, I'm going to sustain the appeal from the Bankruptcy Court and remand the matter to the Bankruptcy Court to delete the allocation provisions in the reorganization plan and for such other proceedings as may be required. The trustee may have an exception. I'm going to ask the government to prepare a form of order.

(Proceedings concluded)

APPENDIX D

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

Chapter 11
Nos. 83-00060-JG
83-00128-JG
83-00129-JG
83-00130-JG
83-00131-JG

IN RE:

ENERGY RESOURCES, CO., INC.,
ENERGY OPERATORS, INC.,
OILFIELD INNOVATIONS, INC.,
OILFIELD RESOURCES CO., INC. (TEXAS),
OILFIELD RESOURCES CO., INC. (DELAWARE)
DEBTORS

MEMORANDUM

This matter is before the Court on the motion of William A. Browner, Liquidation Trustee (the "Trustee") of the Erco Liquidation Trust (the "Trust") established under the Debtor's Third Amended Plan of Reorganization (the "Plan"). The Trustee seeks an order directing the Internal Revenue Service ("IRS") to apply payments under the Plan as designated by him. The IRS opposes the Trustee's motion. Both parties have briefed their respective positions. The factors are undisputed.

FACTS

On January 17, 1983 and January 31, 1983, the debtors, Energy Resources Co., Inc. and its affiliates, commenced proceedings under Chapter 11 of the Bankruptcy Code. By order dated September 5, 1984, this Court confirmed the debtors' Plan pursuant to which the Trust was established. The purpose of the Trust, as the IRS notes in its brief, is to liquidate all remaining assets of the debtors for the benefit of their creditors.

Pursuant to Article 5 of the Plan, claims of taxing authorities, including the IRS, are to be paid in full either upon such terms as the debtors and the taxing authorities may agree or in accordance with section 1129(a)(9)(C) of the Code in four equal annual payments commencing one year after the Confirmation Date (as defined in the Plan and ultimately determined to be October 1, 1984).[1] The annual payments include a repayment of principal together with interest at the statutory rate established by the Secretary of the Treasury pursuant to 26 U.S.C. § 6621. In addition to the annual payments, the Plan provides that the Trustee has the right to prepay tax claims at anytime.

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[1] The Court's order of September 5, 1984 indicates that:

> By agreement of the Debtors, Article 5 of the Plan shall be deemed modified to provide that all Finally Allowed tax claims covered thereby shall be paid over a period of four years from the Confirmation Date, as defined in the Plan, and not from the Consummation Date, and that, in any event, the Debtors and thereafter the Trustees, as defined in the Plan, shall use their best effort consistent with the payment of priority claims and administrative expenses and consistent with their duties, including their expenses under the Erco Liquidation Trust Agreement, to prepay all Finally Allowed tax claims, in whole or in part, prior to the four anniversary dates described in Article 5 of the Plan.

On November 6, 1985, the Trustee made payments to the IRS in accordance with the Plan in the amounts of $203,516.54, representing the Plan payment then due, and $78,000, representing a partial prepayment of the outstanding claim. In so doing, the Trustee designated "that this payment be applied to the trust fund portion of taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982."[2]

The IRS refused to acknowledge the Trustee's designation of the payment. In a letter dated November 7, 1985, its Bankruptcy Advisor advised the Trustee that "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment which is a distribution of a bankruptcy proceeding to its maximum benefit." As a result of the refusal of the IRS to honor his designation, the Trustee moved for an order directing the IRS to apply Plan payments as designated by the Trustee. In his motion, the Trustee argued *inter alia*:

> 1) that the ability of the Trustee to direct payments is necessary for the Trustee to maximize the benefit to the estate from such payments;
>
> 2) that the IRS will not be harmed by the designation, since the Plan provides for the payment in full of the IRS' claim, plus interest;

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[2] The court in *Muntwyler v. United States*, 703 F.2d 1030 (7th Cir. 1983) described trust fund taxes as follows:

> The Internal Revenue Code directs employers to deduct and withhold a tax upon wages paid. 26 U.S.C. § 3401(a). The withheld taxes are deemed to be held in a special fund in trust for the United States, *id.* §7501(a), and accordingly every person required to collect and pay over such a tax (including an officer of the corporation . . . , *id.* § 6671(b)) is personally liable for the full amount of the tax not paid, *id.* § 6672.

Id. at 1032.

3) that by directing payments, the Trustee is able to implement a settlement agreement with Richard Rosen, a former officer, whereby $14,000 was immediately released to the Trust and the Trustee agreed to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them and their ability to cooperate with the Trustee; and

4) that payments made under a plan of reorganization pursuant to 11 U.S.C. § 1129(a)(9)(C) are voluntary and, therefore, entitled to be designated.

In its response to the Trustee's motion, the IRS focused on the Trustee's final argument, asserting that payments made to the United States pursuant to a Chapter 11 plan are "involuntary" and the manner of their application is in the sole discretion of the United States. The question then presented for the Court is whether, in fact, tax payments made pursuant to a confirmed Chapter 11 plan of reorganization are voluntary or involuntary.

DISCUSSION

The starting point for any discussion is the general rule that a taxpayer who makes a "voluntary" tax payment to the IRS may designate, at the time of payment, the manner of allocation of such payment among tax, penalty and interest, *Muntwyler v. United States*, 703 F.2d 1030 (7th Cir. 1983); *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), whereas a taxpayer who makes an "involuntary" payment may not designate the manner of its allocation, the IRS being free to apply such payment to maximize the amount of assessed tax that may be collected, *United States v. DeBeradinis*, 395 F.Supp. 944 (D. Conn. 1975), *aff'd*, 538 F.2nd 315 (2d Cir. 1976); *United States v. Augspurger*, 508 F.Supp. 327 (W.D.N.Y. 1981).

Courts have adopted the United States Tax Court's definition of an involuntary payment set forth in *Amos v. Commissioner*, 47 T.C. 65 (1966). It provides:

> An involuntary payment of federal taxes means any payment received by agents of the United States as a result of a distraint or levy from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

Id. at 69. For example, the United States Court of Appeals for the Seventh Circuit stated:

> The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim or, as appears to be a logical extention of the Government's position, telephoning or writing the taxpayer to inform him of taxes due.

Muntwyler, 703 F.2d at 1033.[3]

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[3] In *Muntwyler*, a corporation which was delinquent in paying its federal withholding taxes entered into a common law assignment to a trustee for the benefit of creditors. The IRS filed a claim with the trustee. When the trustee sent monies to the IRS, instructing that payments be applied to the trust fund portion of the corporate tax liability so that the 100% penalty assessment against the responsible officer would be partially satisfied, the IRS refused to follow his instructions. The responsible officer then filed suit seeking a refund from the IRS. The district court ruled that trustee's payment to the IRS was voluntary.

Although courts are in agreement as to the definition of "involuntary" payment, partly because of dictum in *Muntwyer*,[4] they diverge from there, leading to conflicting precedent as to whether payments to the IRS pursuant to a bankruptcy proceeding are involuntary. *Cf. In re Lifescape, Inc.*, 54 B.R. 526, 527 (Bankr. D. Colo. 1985). However, recent decisions are in agreement that the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary. *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985); *In re A&B Heating & Air Conditioning, Inc.*, 53 B.R. 54 (Bankr. M.D. Fla. 1985); *In re Franklin Press, Inc.*, 52 B.R. 151 (Bankr. D. Fla. 1985); *accord In re Hartley Plumbing Company, Inc.*, 32 B.R. 8 (Bankr. M.D. Ala. 1983); *cf. Hineline v. Household Finance Corp.*, No. 85-0100 (Bankr. N.D. Ohio Jan. 27, 1986).

The courts in the *In re Lifescape, Inc.* and *In re A&B Heating & Air Conditioning, Inc.* cases, both of which involved Chapter 11 debtors seeking to allocate payments to the IRS so that the trust fund portion of the IRS' claim would be credited first until paid in full, stressed the options a debtor has under section 1129 of the Code and the nature of the court's involvement. In a rationale specifi-

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[4] For example, the court in footnote two indicated:

> The Government might have been correct in its claim if the corporation had been in bankruptcy, which it was not. An assignment for the benefit of creditors is an act of bankruptcy and presumably any creditor, including the Government, could have proceeded to file an involuntary petition for bankruptcy based thereon. . . . We do not equate the assignment for the benefit of creditors with a formal bankruptcy proceeding.

703 F.2d at 1034 n. 2.

cally adopted by the court in *In re Lifescape, Inc.*, the court in *In re A&B Heating & Air Conditioning Co., Inc.* stated:

> Court involvement in the context of a Chapter 11 reorganization case is not the type which results in seizure of property or money as in a levy. Unlike a taxpayer faced with a government instituted collection proceeding which may lead ultimately to levy upon the taxpayer's assets, a Chapter 11 debtor enjoys great latitude in how and if a plan is proposed and thus how and when the IRS will be paid. § 1129 requires only that a plan provide for payment of prepetition taxes over a period not to exceed 6 years from the date of assessment in order that it may be confirmed. The debtor propounding a plan has a number of options with respect to treatment of a claim by the IRS and *it is the freedom afforded by these options which dictates the conclusion that payments to the IRS pursuant to a confirmed Chapter 11 plan of reorganization are voluntary.*

53 B.R. at 57 (emphasis supplied).

Likewise, the court in *In re Franklin Press, Inc.* found that payment made pursuant to a Chapter 11 plan was voluntary. In that case, the reorganization was funded by the infusion of outside capital provided or guaranteed by a third party. The court held that this established voluntariness since the third party was not subject to the court's control, in contrast to a debtor in liquidation without real options. Significantly, the Plan in the instant case and the tax payments at issue were made possible, at least in part, by the infusion of capital from Enseco, Inc.[5]

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[5] *See* Stipulation Regarding Management, Plan Funding and Asset Purchase filed March 26, 1984, Modification of Stipulation Regarding Management, Plan Funding and Asset Purchase filed April 13, 1984,

Since the facts of the cases just discussed are similar to the ones in the instant case, the Court finds their reasoning persuasive. Furthermore, the three cases primarily relied upon by the IRS are distinguishable from the instant case and the cases just discussed. For example, *In re Frost*, 47 B.R. 961 (D. Kan. 1985), unlike the instant case, did not involve section 1129. In that case, the district court, citing *Muntwyler*, reversed the bankruptcy court, which had held that payments made under a Chapter 13 plan are voluntary, because the IRS had filed a claim and because the plan had to comply with the Bankruptcy Code. The district court's reliance on the proposition that *Muntwyler* makes it clear that it is the involvement of the court and not the type of bankruptcy which makes payments by a debtor involuntary is open to serious question, *see In re Lifescape Inc.*, 54 B.R. at 529. Therefore, this Court will not follow its lead, particularly in view of the fact that section 1129 was not involved.

Likewise, in *In re Avildsen Tools and Machines, Inc.*, 40 B.R. 253 (D.C.N.D. Ill. 1984), section 1129 was not involved. In that case, both judicial orders and a judicial sale concerned the district court. Furthermore, the bankruptcy court's orders, approving and confirming the sale of the debtor's assets and authorizing the debtor to pay its liabilities from the proceeds, were issued pursuant to the Bankruptcy Act which required more court involvement in case administration than under the Code.

Finally, *In re Mister Marvins, Inc.*, 48 B.R. 279 (E.D. Mich. 1984), is distinguishable because it involved a liquidation of the debtor's assets pursuant to a court order which authorized the settlement of a claim. As the court in

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this Court's Order, dated April 13, 1984, Approving and Allowing Debtor's Motion for Approval of Stipulation with Ensco, Inc., and the Debtor's Third Amended Plan of Reorganization.

In re A&B Heating & Air Conditioning, Inc. observed, "the [c]ourt in the *Mister Marvins* case was clearly more active than is a court whose only concern is to determine if the proposed plan of reorganization meets the standards set forth in § 1129." 53 B.R. at 56.

The Court, therefore, concludes that the Trustee's payment to the IRS, pursuant to Article 5 of the debtors' confirmed Plan, as modified by the Court's order of September 5, 1984, was voluntary and that the Trustee had every right to direct the IRS to allocate the payments to the trust fund portion of taxes owed. The Court is persuaded not only by the recent cases unequivocally holding that payments made pursuant to section 1129 are voluntary but by common sense as well.

Historically, bankruptcy has been a statutory vehicle for aid to those in financial need. Congress, through the Bankruptcy Code, has provided bankrupts with extensive protection from their creditors and a reasonable opportunity to rehabilitate not only for their benefit but for that of the public as well.

Although the IRS' argument that it has the statutory responsibility to collect all taxes from all taxpayers who may be liable for their payment is persuasive and indeed laudable [redacted] in most contexts, this Court believes that Congress has tempered that objective in the bankruptcy context, albeit in a limited fashion. The Court cannot agree with the IRS' contention that an act is involuntary simply because it occurs in a bankruptcy proceeding. Such an assertion flies in the face of Congressional concern for the rehabilitation of bankrupts, the dictionary definition of voluntary* and the consistent usage of the word

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* The word voluntary is defined in Webster's New Collegiate Dictionary as "1: proceeding from the will or from one's own choice or consent 2: unconstrained by interference: self-determining. . . ."

involuntary by practitioners and scholars to distinguish cases commenced pursuant to 11 U.S.C. § 303 from other cases.

Furthermore, the Court is mindful that the IRS had the opportunity to voice its concern with respect to the allocation issue at the time of the confirmation hearing but did not do so.[7] Although the Plan does not state specifically that all payments to the IRS will be credited first to the trust fund portion of the IRS claim until it is paid in full, the likelihood that the Trustee would seek such a designation was foreseeable. Indeed, both the Plan and Erco Liquidation Trust Agreement repeatedly emphasize the Trustee's broad powers to act for the benefit of creditors.[8] The Court is inclined, therefore, to view the Plan and the Trustee's authorized actions pursuant to it, including the designation of tax payments, as binding. As the court observed in *In re St. Louis Freight Lines, Inc.*, 45 B.R. 546 (Bankr. E.D. Mich. 1984), with respect to its jurisdiction to interpret the terms of a confirmed plan and the distribution of post-petition, pre-confirmation taxes:

> Section 1141(a) of the Code provides that confirmation binds the debtor, creditors and other parties in interest to the terms of the plan, even if a party has not accepted the plan. Case law has established the binding contractural nature of the plan. This rule has recently been used to bind the IRS and other taxing

[7] The IRS filed an objection to the debtors' Plan on August 1, 1984 on the grounds that the payment schedule would extend beyond the six years from the earliest day of assessment. It withdrew its objection in open court on the date of confirmation, September 9, 1984.

[8] For example, Article 5.1(h) of the Trust Agreement gives the Trustee the power to "amend this agreement in any manner whatever, provided that no such amendment shall permit the Trustee to engage in any activity prohibited hereunder and provided no such amendment shall limit the Rights of Beneficiaries."

> authorities to the terms of the debtor's confirmed plan. It is equally well established that an order confirming a plan is an appealable order that has *res judicata* effect *on all issues that could have been raised regarding the claim.* In other words, a party in interest . . . is bound by the plan when confirmed, even if the plan ultimately provides it with less than that to which it is otherwise legally entitled.

Id. at 551-52 (footnote omitted, citations omitted, emphasis supplied).

In view of the foregoing, the entire record of the case, and arguments of counsel whether or not mentioned herein, the Trustee's motion is allowed and the IRS is hereby ordered to apply tax payments under the Plan as designated by the Trustee.

By the Court,

/s/ JAMES N. GABRIEL
James N. Gabriel
Bankruptcy Judge

Dated at Boston in said District, this 7th day of April, 1986

APPENDIX E

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF RHODE ISLAND

BK No. 8500723

IN RE:

NEWPORT OFFSHORE, LTD., DEBTOR

DECISION AND ORDER OVERRULING THE OBJECTION BY THE INTERNAL REVENUE SERVICE TO ARTICLE III OF THE TRUSTEE'S PLAN OF REORGANIZATION

Before: Arthur N. Votolato, Jr., United States Bankruptcy Judge

Heard on the objection of the United States, on behalf of the Internal Revenue Service (IRS), to that portion of the Chapter 11 trustee's plan of reorganization which seeks to designate the manner in which IRS should apply plan payments to prepetition tax liabilities.[1]

Article III of the plan proposes to pay all Class Four claims, those of all the taxing authorities,[2] through "payment . . . of deferred cash payments over a period not in excess of six years after the date of assessment of such claim" pursuant to 11 U.S.C. § 1129(a)(9)(C). Interest on those claims will be paid according to the rate set forth in

[1] The order confirming the plan was signed on April 3, 1987, but this issue was reserved pending a ruling on the objection by IRS.

[2] Class Four claims consist of taxes owed to IRS, the State of Rhode Island, the Rhode Island Department of Employment Security, and the City of Newport.

26 U.S.C. § 6621. In addition, and in dispute, is that part of the plan which designates how the tax payments should be applied. Specifically, the plan provides that payments be credited first to the " 'trust fund'[3] portion of the . . . oldest taxes," second to the "interest on such trust fund portion of such taxes," and third, to "the oldest non-trust fund portion of the remaining tax obligations and the interest thereon." *See* Trustee's Plan of Reorganization, Article III at 7-8. IRS objects to the application of the tax payments as proposed,[4] and argues that it be permitted to apply the tax payments first to the non-trust fund taxes, in accordance with established IRS policy. *See Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir. 1983).

IRS and the trustee agree that if the tax payments are "voluntary," the debtor may designate how the payments should be applied. *See Muntwyler v. United States, supra*, at 1032. Conversely, if the payment is involuntary, the debtor does not have the power to direct application of the payments.

If it had its druthers, IRS would apply payments first to the non-trust fund taxes due, *see* IRS Memorandum in Support of the Objection to the Trustee's Plan at 5, essentially the opposite of how the trustee would direct the application of payments. Not surprisingly, the purpose of this IRS policy is to preserve the personal liability, created by 26 U.S.C. § 6672, of "[a]ny person required to collect,

[3] Trust fur [4] taxes are those required to be withheld pursuant to 26 U.S.C. § 7501 and which "shall be held to be a special fund in trust for the United States." They include the tax collected from employee wages, and the employee share of FICA tax. *Holcomb v. United States*, 622 F.2d 937, 938 (7th Cir. 1980).

[4] The other taxing authorities which did not object to the manner in which the plan directs payments to be applied to Class Four claims are bound by the order confirming the plan to apply them as directed. 11 U.S.C. § 1141(a).

truthfully account for, and pay over any tax imposed by this title." If IRS were unable to collect the full amount of trust taxes from the debtor, it then could proceed against the "responsible person," as defined by 26 U.S.C. § 6671(b), for the unpaid portion of those taxes. There is no personal liability for unpaid non-trust fund taxes. *See In re Mister Marvins, Inc.*, 48 B.R. 279, 280 (E.D. Mich. 1984). While IRS policy is to apply involuntary payments first to non-trust fund obligations, "there is no tax code provision regarding this subject." *In re Technical Knockout Graphics, Inc.*, 68 B.R. 463, 465 (9th Cir. B.A.P. 1986).

The most frequently cited definition of an involuntary payment, *Muntwyler v. United States, supra*, at 1032, is that of the Tax Court in *Amos v. Commissioner*, 47 T.C. 65, 69 (1966):

> An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

However, in applying that definition the Seventh Circuit has stated that

> [t]he distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money, as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim.

703 F.2d at 1033 (emphasis in the original).

In *Muntwyler*, which involved a non-judicial assignment for the benefit of creditors, the Seventh Circuit held that "merely filing a claim for back taxes" absent some form of "enforced collection measures" did not render the payment involuntary. *Id.* at 1033. IRS contends that the filing of a bankruptcy petition is sufficient "court action" under *Muntwyler* to render "any payment [of taxes] in a bankruptcy proceeding . . . *per se* involuntary." *See* IRS Memorandum at 15. Apparently, IRS draws this conclusion from note 2 of *Muntwyler*, 703 F.2d at 1034, where the court stated that "[t]he Government might have been correct in its claim if the corporation had been in bankruptcy, which it is not." However, the note continues "[a]n assignment for the benefit of creditors is an act of bankruptcy [under the 1898 Act] and presumably, any creditor, including the Government, could have proceeded to file an involuntary petition for bankruptcy based thereon." At best, it is unclear whether the Seventh Circuit meant that the requisite "court action" referred to filing a proof of claim, or to the filing of an involuntary bankruptcy petition, followed by a proof of claim. The difference between the two forms of "court action" is significant, and for our purposes is in fact dispositive.

The trustee disagrees with the *per se* test advanced by IRS, and reads *Muntwyler* in a different light. "In the instant matter, the IRS has merely filed a proof of claim. There has been no court action with respect to the IRS' claim, let alone 'court action [or administrative action][3] resulting in an actual seizure of money or property as in a levy' " (citing *Muntwyler, supra*, at 1033). *See* Trustee's Memorandum at 7. The trustee construes the phrase "resulting in an actual *seizure*" to apply to court action as

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[3] The trustee's memorandum omitted the bracketed portion of the quotation.

well as administrative action.[6] In any event, the trustee argues that some type of " 'enforced collection measure,' " *Muntwyler, supra,* at 1033, beyond the filing of a proof of claim, is necessary to qualify as "involuntary," payments made under a Chapter 11 plan of reorganization.

Several courts have already faced the issue of determining voluntary versus involuntary payments, within the context of a bankruptcy case. The trustee's position that payments to IRS pursuant to a Chapter 11 plan are voluntary is supported by the following: *In re Technical Knockout Graphics, Inc., supra*; *In re Energy Resources Co., Inc.*, 59 B.R. 702 (Bankr. D. Mass. 1986); *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985); *In re A & B Heating & Air Conditioning, Inc.*, 53 B.R. 54 (Bankr. M.D. Fla. 1985); *In re Franklin Press, Inc.*, 52 B.R. 151 (Bankr. S.D. Fla. 1985). On the other side of the coin, although none have phrased their conclusions as strongly as a *per se* rule, the following courts support the IRS position that payments of tax claims in bankruptcy are involuntary: *In re Mister Marvins, Inc., supra*; *In re Frost*, 47 B.R. 961 (D. Kan. 1985); *Matter of Avildsen Tools & Machine, Inc.*, 40 B.R. 253 (N.D. Ill. 1984); *aff'd* 794 F.2d 1248 (7th Cir. 1986); *In re Vincent-McCall Co.*, 68-2 USTC (CCH) ¶ 9591 (E.D. Wisc. 1968) (Act case, referee's opinion). In affirming the district court in *Avildsen Tools*, however, the Seventh Circuit stated "[w]e do not have to decide whether a payment for delinquent pre-bankruptcy petition taxes made to the government is voluntary or involuntary" since the debtor had breached

[6] IRS reads the language more restrictively and, apparently, feels that the qualifier "resulting in an actual seizure," applies only to "administrative action," and that *any* "court action" within the bankruptcy case, even if it involves only the filing of a proof of claim, renders the payment involuntary.

its agreement as to how the tax payments would be applied. 794 F.2d at 1252. Since the debtor breached its agreement with IRS, the government was no longer bound as to how the payments would be applied. *Id.* at 1254. It appears, therefore, that no Court of Appeals has squarely decided the issue of whether payments under a plan pursuant to § 1129 are voluntary or involuntary.

In re B & P Enterprises, Inc., 67 B.R. 179 (Bankr. W.D. Tenn. 1986) reaches a more flexible conclusion about midway between the positions taken by the parties. There, the bankruptcy court rejected both the IRS *per se* rule, and any ruling wherein the trustee or debtor-in-possession could unilaterally direct the allocation of payments under a confirmed plan to the trust fund portion of the IRS claim. *Id.* at 183. Instead, the court held that such questions should be decided on a case-by-case basis, and set out what it considered were the relevant factors in the analysis.[7] *Id.* at 184.

We feel that the Court's approach in *In re B & P Enterprises, Inc., supra*, is more workable than either of the rigid approaches advocated by the parties. Taking full advantage of our new found flexibility, and considering the "totality of the facts and circumstances," *id.* at 184, of this case, we conclude that the trustee should be allowed to direct the application of payments to IRS as set forth in the plan. Except for filing a proof of claim, the only involvement of IRS in any court action in this case has been

[7] The factors include: (1) the history of the debtor; (2) whether IRS has taken any pre-bankruptcy collection or "enforced collection measures" against the debtor or the appropriate responsible person; (3) the nature of the Chapter 11 plan (*e.g.*, reorganization or liquidation); (4) the presence, nature and extent of administrative and/or court action; (5) existence of exceptional or special circumstances warranting allocation provided by the plan. *In re B & P Enterprises, supra,* at 184.

to press the objection to confirmation. IRS has not (nor had it previously) taken any "enforced collection measures." The plan calls for reorganization as a going concern, rather than liquidation of assets and conversion to Chapter 7. Most importantly, however, the funding for this plan comes from a third party, Allied Marine Associates. Other courts have held that third-party funding alone is sufficient to render payments to IRS voluntary. *See In re Energy Resources Co., Inc., supra*; *In re Franklin Press, Inc., supra.* In the real world of business reorganization, most successful Chapter 11 plans depend, in part, at least, on the infusion of funds provided by outside investors. The inflexible application of the *per se* rule advanced by IRS would remove the initiative of former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan. If the purpose of Chapter 11 is to rehabilitate rather than liquidate debtors, the Court's role in this process is greatly enhanced by allowing the judge to review each case on its own merits and to confirm those which meet the requirements of § 1129. Using that approach in this case, we conclude that the third party payments constitute sufficient "special circumstances," *In re B & P Enterprises, Inc., supra,* at 184, to allow the trustee to allocate such payments first, to the trust fund portions of the debtor's tax liabilities and, thereafter, to the non-trust fund amounts.

IRS expends considerable argument on two points which deserve comment. IRS argues that allowing the allocation of payments to trust fund taxes unfairly benefits the "responsible person" as defined by the Internal Revenue Code, and shifts the risk of non-payment of the tax liability to the government. In this case, however, IRS fails to identify the responsible person to whom it

ascribes such remarkable influence over the plan proposed by the trustee.[8] That person, who we surmise (since IRS has not told us) might be the "responsible person," a mid-level financial employee, is neither a principal of the debtor nor a major stockholder, and does not directly benefit from the plan (except perhaps for payment of a priority wage claim, along with all other employees). The contention that the sole purpose of this part of the plan is to benefit Kevin Walsh, the controller, is a theoretical argument with no factual or practical supprt. IRS also argues that the plan could likely fail as soon as the trust fund tax liabilities are paid, and the responsible person relieved of any potential assessment under 26 U.S.C. § 6672. As we view it, a plan likely to fail in the manner IRS describes would not be confirmable under 11 U.S.C. § 1129(a)(11) ("[c]onfirmation of the plan is not likely to be followed by the liquidation, or need of further financial reorganization of the debtor . . . unless such liquidation or reorganization is proposed in the plan"). We have already found that the trustee's plan complies with the requirements of §1129, that rehabilitation is likely, and that failure (either prior or subsequent to payment of trust fund taxes) is not the expected route for this debtor.

Therefore, for the foregoing reasons, Article III of the trustee's plan of reorganization regarding the treatment of Class Four tax claims is confirmed, and IRS is ordered to apply the payments as designated in the plan.

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[8] IRS does not argue that the trustee is the "responsible person" seeking to avoid personal liability under the plan.

Dated at Providence, Rhode Island this 14th day of July, 1987.

/s/ ARTHUR N. VOTOLATO, JR.
Arthur N. Votolato, Jr.
Bankruptcy Judge

APPENDIX F

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 87-1896

IN RE: ENERGY RESOURCES CO., INC., DEBTOR

INTERNAL REVENUE SERVICE, PLAINTIFF, APPELLANT

v.

ENERGY RESOURCES, CO., INC., DEFENDANT, APPELLEE

Entered March 31, 1989

JUDGMENT

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed.

By the Court:

/s/ FRANCIS P. SCIGLIANO
Francis P. Scigliano
Clerk

APPENDIX G

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 88-1175

IN RE: NEWPORT OFFSHORE, LTD., DEBTOR

UNITED STATES OF AMERICA, PLAINTIFF, APPELLEE

v.

NEWPORT OFFSHORE, LTD., DEFENDANT, APPELLANT

Entered March 31, 1989

JUDGMENT

This cause came on to be heard on appeal from the United States District Court for the District of Rhode Island, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the district court is reversed.

By the Court:

/s/ FRANCIS P. SCIGLLANO

Francis P. Scigllano
Clerk

U.S. GOVERNMENT PRINTING OFFICE: 1989—241 699/00348

(2)

No. 89-255

Supreme Court, U.S.
FILED
OCT 20 1989
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

JOINT BRIEF IN OPPOSITION TO THE UNITED STATES OF AMERICA'S PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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15 pp

Question Presented

Whether a bankruptcy court, in balancing the interests of all creditors, may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability.

List of Parties

The parties to the proceedings below were the United States of America, petitioner, and William A. Browner, Trustee of the ERCO Liquidation Trust, and Robert Cataldo, as Chapter 11 Trustee of Newport Offshore, Ltd., respondents.[1]

[1] Energy Resources Co., Inc. and Newport Offshore, Ltd. were erroneously named as parties in the caption of the decision below.

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No. 89-255

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JOINT BRIEF IN OPPOSITION TO THE UNITED STATES OF AMERICA'S PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The citations to the opinions and judgments delivered below, the statement of the grounds on which the jurisdiction of this Court is invoked, the recitation of the statutes applicable to

these cases and the statement of the case as presented in the United States of America's Petition for Writs of Certiorari ("Petition") are satisfactory to the respondents and need not be restated. Furthermore, we adopt the Petition's appendix ("App.") for purposes of any citations herein.

Reasons for Denying the Writ

The Petitioner has stated that "[t]he court of appeals has erroneously decided an important . . . question of federal law, in direct conflict with the decisions of other courts of appeals." Petition at 11. The decision below is not erroneous, is not in direct conflict with the decisions of other courts and does not as a practical matter decide an important question.

I. The First Circuit's Decision Does Not Produce a Direct Conflict Among the Circuit Courts such as to Warrant Grant of Certiorari.

The Petitioner is incorrect in contending that the First Circuit acknowledged that its decision "directly conflicts with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987)." Petition at 12. What the First Circuit did acknowledge was that upon the application of the test announced by it to the facts of the cases before it, its result was not consistent with the result reached by the Third Circuit in *In re Ribs-R-Us* (App. 4a). The Third Circuit had announced a *per se* rule that payments to the Internal Revenue Service ("IRS") were "involuntary" and that such payments could not be designated by the Chapter 11 debtor or the bankruptcy court to the debtor's trust fund liabilities. 828 F.2d at 204. The First Circuit agreed

with the Third Circuit in accepting the IRS's view that "payments made pursuant to a Chapter 11 plan are 'involuntary' for purposes of its [IRS's] own rules" (App. 12a) and rejected the argument proffered by respondents that all such payments are *per se* "voluntary." The First Circuit, however, in finding that a bankruptcy court may nevertheless order the IRS to apply a payment in a way that runs counter to its own internal policies, fashioned the following *case by case* test to determine under what circumstances tax payments may be allocated:

> ". . . upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, i.e., increased likelihood of payment to creditors who might otherwise lose their money?" (App. 21a).

Thus, not only did the First Circuit not establish a *per se* rule at odds with the Third Circuit, but it offered a discretionary test which, had that court before it the same facts that were before the Third, Sixth and Ninth Circuits respectively in *In re Ribs-R-Us, supra*; *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988); and *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987), it might well have come to precisely the same result those courts arrived at. Perhaps more importantly, in cases like this one, certiorari should be granted only where there is "a real and embarrassing conflict of opinion and authority between the Circuit Courts of Appeals." *N.L.R.B.* v. *Pittsburgh S.S. Co.*, 340 U.S. 498, 502 (1951). That standard has not been met; until the bankruptcy courts within the First Circuit are afforded the opportunity of applying the above test, there is no way of knowing whether or not

(i) it will be very narrowly construed, (ii) it will have a significant impact, or (iii) it will influence courts outside the First Circuit.

II. The Question Presented is not of Practical Importance to the Administration of the Bankruptcy or the Tax Laws.

A. *The IRS Will Continue to have Ample Opportunities to Collect Unpaid Trust Fund Taxes from Responsible Persons and Minimize Any Risk to the Treasury.*

In order to prevent a loss to the treasury, Congress, through Section 6672 of the Internal Revenue Code, provided that if the persons in a corporation responsible for collecting, accounting for and paying over such "trust fund" taxes to the government willfully fail to do so, they each become personally liable for a "penalty" in the full amount of the unpaid trust fund taxes. The Petitioner is thus wrong when it argues that the First Circuit's decision "allows responsible persons to use the corporate Chapter 11 proceedings as a shield to protect themselves from Section 6672." Petition at 18. As the Court specifically noted:

> "And, so long as there is a 'trust fund' tax debt outstanding, nothing, including our opinion today, legally restrains the IRS from attempting to collect 'trust fund' taxes from 'responsible' individuals. *See In re LaSalle Rolling Mills*, 832 F.2d 390 (7th Cir. 1987) (Anti-injunction Act prohibits courts from restraining IRS from collecting 'trust fund' taxes from individuals under § 6672); *A to Z Welding & Manufacturing Co.* v. *United States*, 803 F.2d 932 (8th Cir. 198[6]) (same); *Huckabee Auto Co.*, [783 F.2d 1546 (11th Cir. 1986)]."

(App. 20a).

Under Section 7421 of the Internal Revenue Code, the so-called "Anti-Injunction Act," no court has the right to restrain "the assessment or collection of any tax." Thus, there is no "shield" that protects any responsible person from Section 6672 and none was asserted by the responsible persons affected by the decisions in the cases at bar. The three court of appeals cases cited in the above quotation from the First Circuit's opinion all represent attempts in corporate Chapter 11 cases to enjoin the IRS from pursuing collection of trust fund taxes from officers or shareholders of a Chapter 11 corporation while the corporation sought to reorganize and pay those taxes itself under a plan of reorganization. In each case the court of appeals held that the Anti-Injunction Act prohibited any court from restraining the collection of trust fund taxes under Section 6672, whether or not those same taxes might ultimately have to be paid in full by the corporate debtor in its Chapter 11 case. In light, therefore, of the government's ability to pursue responsible persons before, during and after a successful Chapter 11 case, the government's interest might be jeapordized by the decision below, if at all, only if the IRS fails to exercise the remedies indisputably available to it.

B. *A Chapter 11 Plan Must Be Found Feasible Prior to its Confirmation.*

The precise issue presented by this case can only arise after the bankruptcy court has entered an order confirming a reorganization plan. 11 U.S.C. §§ 1129, 1141(a). Before such confirmation, thirteen specific requirements, as set forth in 11 U.S.C.

§ 1129(a), must be met. Among those are requirements that (i) the plan must provide for the full payment of priority taxes within six years of assessment, 11 U.S.C. § 1129(a)(9)(C), and (ii) the plan must be feasible, i.e., that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan. . . ." 11 U.S.C. § 1129(a)(11). It is and should be difficult to meet this feasibility requirement, as is demonstrated in the following cases, among many, where the courts were not persuaded and refused to confirm the proposed plan. *In re Clarkson*, 767 F.2d 417, 419-20 (8th Cir. 1985) and *In re Merrimack Valley Oil Co., Inc.*, 32 Bankr. 485, 487-91 (Bankr., D. Mass. 1983). Accordingly, the IRS has in all cases full opportunity to press for liquidation of the debtor, and thus payment of its priority taxes forthwith, where it believes and can show that no plan is "feasible." Where, alternatively, the bankruptcy court has determined that the plan proponent has met its burden of proof, the court has effectively made a finding promoting administration of the tax laws and maximizing the likelihood of payment.

C. *Application of the First Circuit's Test May Not Result in Allocation of Tax Payments.*

Clearly, the First Circuit's test (App. 21a) is far more restrictive than the *per se* voluntary ruling urged by respondents below. Accordingly, in those few instances where the plan proponent in a successful Chapter 11 case requests the bankruptcy court to compel the allocation of tax payments, the Petitioner is free simply to resist that request by arguing on the merits that the compulsory allocation will not in fact meaningfully contribute to the reorganization and/or the "increased likelihood of payment to creditors who might otherwise lose their money." (App. 21a).

D. *The United States Overstated the Alleged Fiscal Impact of the First Circuit's decision.*

On page 21, notes 8 and 9 of the Petition, the Petitioner cited an unidentified "report" of the Administrative Office of United States Courts that 90% of Chapter 11 reorganizations fail and an unidentified and unsupported estimate that up to $34 million could be lost if designations are permitted "routinely." These references are *not* in the record below, must be ignored and are in any event seriously misleading. Clearly, if certiorari is not granted, any adverse fiscal impact will be limited to those few future cases, if any, where the First Circuit's test is applied to allow allocation and then only where the plan ultimately fails before payment in full and the responsible persons are not pursued successfully either initially or after failure of the plan. Equally clearly the cited "report" referenced in *In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 382 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988), is irrelevant to the question presented here because it appears to stand only for the proposition that 90% of cases filed under Chapter 11 do not result in confirmed, non-liquidation plans, and *not* the proposition that 90% of confirmed reorganizations fail before payments are completed.

III. The First Circuit's Decision Is Correct.

The decision of the court of appeals, "that the law does authorize a bankruptcy court to order the IRS to allocate [tax payments under a confirmed reorganization plan] . . . to a taxpayer's 'trust fund' liability first" (App. 6a), is correct. This authority derives from the bankruptcy court's broad equitable powers to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of" the

Bankruptcy Code, as codified in 11 U.S.C. § 105(a). The court of appeals recognized that the bankruptcy court may exercise this equitable power to designate the application of tax payments only if the "court reasonably concludes that this allocation will likely increase the reorganization plan's chances for success." (App. 6a-7a). Only in this manner can the potentially conflicting policies of the Bankruptcy Code, favoring rehabilitation of the debtor in the interest of all creditors, and of the Internal Revenue Code, favoring collection of tax revenue above all, be reconciled.

The Petitioner's position, that the IRS may apply the debtor's tax payments as it (the IRS) sees fit, stems from its assertion that these payments are "involuntary," a characterization on which the case law is divided but that the court of appeals accepted for the limited purposes of the IRS's application of its own rule. The distinction between this treatment of voluntary and involuntary payments, in turn, derives originally from non-tax cases applying common law principles to the effect that a debtor may not designate how a payment is to be applied where the payment is seized from him by distraint or court action akin to distraint. *Amos* v. *Commissioner*, 47 T.C. 65, 68-69 (1966).

However, under this common law concept, even though a debtor cannot designate the application of an "involuntary" payment, it does not follow automatically that the creditor can unilaterally make that decision. A number of courts have held that when a court orders a payment, the court itself may prescribe the manner in which the payment must be applied, despite the contrary wishes of the creditor. See e.g. *First National City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D.N.Y 1977) (stating that "where . . . moneys are repaid under judicial order, the court has exclusive authority to apply the funds, and its application must be structured as 'equity and justice require' "); *United States* v. *Transamerica Insurance Company*, 357 F. Supp. 743, 748 (E.D. Va. 1973) (stating that the court must "follow basic principles of equity, seeking to protect the rights and priorities of all the parties"); *Commercial Credit Corporation* v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D.Ark. 1955) (federal district court exercised its equitable powers to set aside IRS allocation of involuntary payment because allocation was unfair to other creditors).

The Petitioner can point to no statute or regulation requiring or even authorizing the IRS to apply a debtor's tax payments under a confirmed reorganization plan in any particular way. There is none. Indeed, a recent legislative effort intended to afford the IRS the power it asserts here failed. (App. 20a). Instead, the Petitioner points to "[t]he IRS's long standing policy" (Petition at 15) embodied in three revenue rulings. Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43, superseding Rev. Rul. 58-239, 1953-1 C.B. 94. But, none of these rulings involves a bankruptcy reorganization or any other judicial proceeding in which a court has ordered the application of the funds after considering the interests of the debtor, the IRS, and other creditors. The cited rulings merely state the IRS's position that it will honor a taxpayer's designation of payments that it makes voluntarily. They do not address at all the issue of whether payments under a confirmed reorganization plan are voluntary or involuntary or how such payments would be treated if they were held to be involuntary.

On that issue there is only an internal IRS policy contained in the Internal Revenue Manual ("I.R.M."). See Internal Revenue Manual, Part V, 57(13)4.3. However, "[b]ecause '[t]heir purpose is to govern the internal affairs of the [IRS],' the procedures of the IRS [contained in the I.R.M.] do not have the force or effect of law." *Vallone* v. *Commissioner*, 88 T.C. 794, 807 (1987), and cases cited therein. Indeed, even with respect to the IRS itself, "the policies and guidelines set forth

in the Internal Revenue Manual are directory, not mandatory." *Timmerman et al.* v. *Swenson et al.*, 79-2 U.S. Tax. Cas. (CCH) ¶9588 (D. Minn. 1979), and cases cited therein.

By contrast, Congress has expressly granted the bankruptcy court authority under 11 U.S.C. § 105(a) "to issue any order . . . that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Surely a mere internal policy of the IRS, one that is not required by any statute or even incorporated in a regulation, should not be accorded such weight as to divest the bankruptcy court of its power to prescribe the application of tax payments under a confirmed Chapter 11 reorganization plan by such an appropriate order.

Conclusion

The petition for writs of certiorari should be denied.

Respectfully submitted,

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ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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REPLY BRIEF FOR THE UNITED STATES

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1. In our petition (at 13-15), we explain that the decision below directly conflicts with the decisions of three other courts of appeals – *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987); *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (6th Cir. 1988); and *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987). The existence of this conflict was expressly acknowledged by the court below (see Pet. App. 4a). Respondents' effort to minimize this conflict (Br. in Opp. 2-4) is unpersuasive.

Respondents acknowledge (Br. in Opp. 3) that the rule adopted by the court below is "at odds with the Third Circuit"; they characterize the decision below as establishing a "discretionary test," in contrast to the "*per se* rule" applied by the other circuits. Respondents argue that this is not a "direct" conflict in result because, they assert, it is not clear that the First Circuit, in applying its "discretionary test" to the facts of the cases decided by the Third, Sixth, and Ninth Circuits, would reach a result different from those reached by those courts. This latter assertion is highly questionable but, in any event, it is quite irrelevant. There can be no doubt that the Third, Sixth, and Ninth Circuits, in applying their "*per se* rule" to the facts of this case, would have held that the IRS was not bound by the requested designation provision that was held by the First Circuit to be binding. This is because the different rules applied by the courts are irreconcilable—three courts of appeals have held that bankruptcy courts cannot allow a corporate debtor in a Chapter 11 proceeding to designate priority tax payments for application first to trust fund liability, but the court below has held that bankruptcy courts do have the power to allow such a designation and upheld effectuation of the designations in these cases. Accordingly, the decision below conflicts both in reasoning and result with the decisions of other circuits. This direct conflict in the courts of appeals on a recurring issue of considerable administrative importance warrants review by this Court.

2. Respondents contend (Br. in Opp. 4-7) that the issue in this case "is not of practical importance to the administration of the bankruptcy or tax laws" (*id.* at 4). In particular, they argue that the IRS's ability to collect its trust fund taxes will not be significantly affected by designation provisions because those provisions will not operate to shield responsible persons from Section 6672 liability. Respondents suggest that the IRS can protect itself against any revenue loss

by taking immediate steps to collect directly from the responsible persons. They also argue that, because Chapter 11 reorganization plans are not confirmed unless they are found to be "feasible" (11 U.S.C. 1129(a)(11)), there is little likelihood that the IRS will not receive full payment of its taxes under the plan.

a. Respondents' assertion that the designation provision will not operate to shield the corporation's responsible persons from Section 6672 liability is plainly wrong. The only purpose of the designation provision is to provide such a shield; if the designation provision were as ineffectual as respondents suggest, the corporate debtor would not pursue it. The corporate debtor itself gains nothing from a designation provision. The plan of reorganization must provide for the payment of all priority taxes, and the corporation is unaffected by the manner in which the payments are applied. Conversely, the responsible persons (who are responsible for the creation of the trust fund tax liability because they willfully failed to pay over the trust fund taxes to the government) directly benefit from the provision. Even if the reorganization fails, their separate Section 6672 liability will be reduced to the extent that the corporate debtor's tax payments have been applied to the trust fund liability, thereby reducing the Treasury's ultimate recovery of the delinquent taxes. Thus, the purpose of the designation provision is to relieve the responsible persons of their Section 6672 liabilities.

The government cannot protect itself against this threat to the revenue by taking immediate steps to collect the liability from the responsible persons. Even if the tax liability could be collected quickly from those persons before the designation provision came into play, which is highly questionable,* that collection would not render the designa-

* The assessment of Section 6672 liability against a responsible person does not necessarily lead to rapid collection of the liability. The

tion provision ineffective. A responsible person has two years to seek a refund of amounts collected from him. 26 U.S.C. 6511(a). See *USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d 1238, 1243 n.6 (5th Cir. 1986). Until the final adjudication of a refund suit or until the expiration of the time for filing a claim for refund, it is not certain that the government will be able to retain any payment made by a responsible person. See *id.* at 1244; *Gens* v. *United States*, 615 F.2d 1335, 1340 (Ct. Cl. 1980). For this reason, the Internal Revenue Manual provides that an assessment against a corporation for trust fund taxes will not be abated upon the satisfaction of the trust fund liability by a responsible person; rather, the assessment is abated upon the expiration of the statutory period for bringing a refund claim. See [2 Administration] Internal Revenue Manual (CCH) para. 5638.1(6), at 6821 (Mar. 1989). Until that time, the designation provision would continue in force and would require the IRS to apply the corporate debtor's tax payments to the unabated trust fund liability. See *United States* v. *A & B Heating & Air Conditioning, Inc.*, 861 F.2d 1538, 1539-1540 (1988), further opinion, 878 F.2d 1311 (11th Cir. 1989). Because IRS policy does not permit collection of more than 100% of the trust fund liability (*USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d at 1243), the amount of the corporate debtor's payments applied to the trust fund liability would

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responsible person may litigate his liability in a refund suit by paying only a small portion of the claimed liability—an amount equal to the taxes owed for one employee for one calendar quarter—and then filing a claim for refund. See Treas. Reg. § 301.7101-1. He may stay collection of the remaining amount of the liability by posting a bond and complying with the other requirements of Section 6672(b). Thus, regardless of how quickly the IRS proceeds against a responsible person, he can delay the collection of most of his liability, and thereby facilitate the reduction of that liability by the payment of the corporate debtor's taxes in accordance with the designation provision.

form the basis for a refund claim by the responsible person (see *United States* v. *A & B Heating & Air Conditioning, Inc.*, 861 F.2d at 1540).

In sum, the initial collection of the trust fund liability from the responsible persons will not defeat the operation of the designation provision or its ultimate consequence of reducing the responsible persons' Section 6672 liability at the expense of the government's collection of the corporation's total tax delinquency. Only where the corporate debtor makes either *no* tax payments or *all* tax payments under the reorganization plan can the designation provision fail to injure the United States' ability to collect the delinquent taxes.

b. There is similarly no merit to respondents' suggestion that designation provisions are rendered unimportant by the requirement that a reorganization plan be "feasible" before it is confirmed. This requirement does not mean that there is little risk that a confirmed plan will fail. Congress clearly recognized that confirmation does not guarantee a successful reorganization. The Bankruptcy Code explicitly provides for conversion of a reorganization proceeding into a liquidating proceeding upon the debtor's failure to effectuate substantial consummation of the plan or upon any other material default under the plan. 11 U.S.C. 1112(b)(7) and (8). Thus, the mere fact that a reorganization plan must be confirmed does not suggest that a designation provision does not pose a serious risk of loss to the Treasury. Indeed, if it were otherwise, respondents would have no reason to insist on the designation—if all of the corporate debtor's taxes are paid as promised in the plan, nothing will remain to be collected from the responsible persons even if the IRS applies the payments as it sees fit.

For the foregoing reasons, and those stated in the petition, the petition for writs of certiorari should be granted.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

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QUESTION PRESENTED

Whether a bankruptcy court may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability, thereby relieving the corporation's responsible persons of their separate liability for those taxes.

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In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 89-255

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 871 F.2d 223. In the *Energy Resources* case, the opinion of the district court (Pet. App. 24a-26a) is unreported; the opinion of the bankruptcy court (Pet. App. 31a-41a) is reported at 59 Bankr. 702. In the *Newport Offshore* case, the oral opinion of the district court (Pet. App. 27a-30a) is unreported; the opinion of the bankruptcy court (Pet. App. 42a-50a) is reported at 75 Bankr. 919.

JURISDICTION

The judgments of the court of appeals (Pet. App. 51a-52a) were entered on March 31, 1989. On June 19,

1989, Justice Brennan extended the time to petition for writs of certiorari to and including August 8, 1989. The petition was filed on August 7, 1989, and was granted on November 13, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 105 of the Bankruptcy Code, 11 U.S.C. 105, provides in pertinent part:

Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. * * *

* * * * *

Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129, provides in pertinent part:

Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

* * * * *

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

* * * * *

(C) with respect to a claim of a kind specified in section 507(a)(7) of this title [referring to priority tax claims], the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

* * * * *

STATEMENT

These two cases were consolidated for purposes of argument and decision in the court of appeals. Each case involves a corporation that is in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*) and owes the government both trust fund and non-trust fund taxes. The trust fund taxes in issue are taxes withheld from the wages of employees and held by the employer in trust for the government under Section 7501 of the Internal Revenue Code (26 U.S.C.).[2] Each person responsible to collect, account for, and pay over trust fund taxes to the government who willfully fails to do so becomes personally liable under 26 U.S.C. 6672 for a penalty in the full amount of the unpaid trust fund taxes. Since the government collects the amount of the unpaid trust fund taxes only once (see *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 (5th Cir. 1986)), the potential Section 6672 liability of each "responsible person" is reduced to the extent that delinquent trust fund taxes are paid by the corporation.

1. In January 1983, respondent Energy Resources Company and its affiliates filed petitions for reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*). At that time, respondent owed about $1 million in taxes, most of which were trust fund taxes. Pet. App. 5a. Under Chapter 11 as in effect at that time, all of

[2] Sections 3102 and 3402 of the Internal Revenue Code (26 U.S.C.) require employers to deduct from wages certain amounts for the employees' income taxes and for the employees' portion of social security taxes. These amounts are to be "held * * * in trust" for the United States and later paid over to the government by the employer (26 U.S.C. 7501). Other corporate tax liabilities that are not withheld from employees' wages, such as corporate income tax and the employer's share of social security taxes, are referred to as "non-trust fund" taxes.

these taxes were entitled to a "sixth priority" (11 U.S.C. 507(a)(6) (1982)).[2] Chapter 11 requires as a condition of confirmation that the reorganization plan provide for payment of all priority tax liabilities over a period not to exceed six years (11 U.S.C. 1129(a)(9)(C)).

a. The bankruptcy court confirmed Energy Resources' third amended plan of reorganization. That plan provided that most of the debtor's assets would be transferred to the ERCO Liquidation Trust, and thereafter liquidated under the supervision of a liquidation trustee for payment to creditors of the estate. The plan provided for payment from the liquidation trust of prepetition tax claims, with interest, in four annual installments beginning on the anniversary of the confirmation date, October 1, 1984. The trustee could prepay the taxes at any time. Pet. App. 5a, 32a.

On November 6, 1985, the trustee transmitted a payment of the prepetition federal tax claims totalling $281,517. The trustee designated "that this payment be applied to the trust fund portion of the taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982." Pet. App. 33a. The Internal Revenue Service (IRS) refused to accept the trustee's designation, maintaining that it had the right to apply the payment to the corporate debtor's outstanding tax liability as it chose. The IRS informed the trustee by letter that, "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment[,] which is a distribution of a bankruptcy proceeding[,] to its maximum benefit." *Ibid.*

[2] Due to a 1984 amendment that added a new category of priority claims, priority federal tax claims are now seventh priority claims. See 11 U.S.C. 507(a)(7).

The trustee thereupon moved the bankruptcy court for an order directing the IRS to apply payments under the plan according to the trustee's designation. In his motion, the trustee argued that he was entitled to designate tax payments under the plan because the payments were "voluntary." He also contended that the designation of payments was necessary for the benefit of the bankruptcy estate. He stated that the designation enabled him to implement a settlement agreement entered into with Richard Rosen, a former officer of the debtor, in which Rosen immediately released $14,000 to the trust, assertedly in exchange for the trustee's agreement "to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them and their ability to cooperate with the Trustee" (Pet. App. 34a). The trustee also asserted that the designation would not harm the IRS because the plan provided, ultimately, for payment of the tax claims in full. The IRS opposed the trustee's motion on the ground that the payment of priority taxes under a Chapter 11 plan is "involuntary," and therefore the IRS is permitted to apply the payment as it chooses. *Id.* at 33a-34a.

b. The bankruptcy court granted the motion and ordered the IRS to follow the trustee's designation (Pet. App. 31a-41a). The court stated the general rule that a taxpayer who makes a "voluntary" tax payment is entitled to designate the manner in which it is to be applied, whereas that authority rests with the IRS if the payment is "involuntary" (*id.* at 34a). Relying on several other bankruptcy court decisions, the court held that "the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary" (Pet. App. 36a), and that the trustee therefore was entitled to designate how the tax pay-

ment should be applied (*id.* at 36a-40a). The court also stated that its conclusion was buttressed by the government's failure to object to confirmation of the plan, even though the plan was silent on the question of designation or the manner in which the tax payments should be applied, because it was "foreseeable" that the trustee would seek such a designation (*id.* at 40a-41a).

c. On appeal, the district court affirmed (Pet. App. 24a-26a). The court stated that the bankruptcy court's role in confirming a plan under Chapter 11 does not make a tax payment thereunder involuntary, because the Bankruptcy Code affords debtors considerable flexibility in Chapter 11. Thus, in the district court's view, the bankruptcy "court here didn't compel action; rather, it approved a payment which a debtor wished to make" (Pet. App. 26a).

2. a. In the *Newport Offshore* case, respondent Newport Offshore filed a petition for reorganization under Chapter 11 on November 13, 1985, and continued operating as a debtor in possession. At the time of the petition, respondent owed about $300,000 in taxes, including both trust fund and non-trust fund taxes. The trustee proposed a plan of reorganization under which a third party, Allied Marine Associates, agreed to pay all of respondent's prepetition tax liability and various other debts, and to invest additional money in the corporation; in return, it would receive 85% of the shares of the new, reorganized Newport Offshore. The proposed plan provided for full payment of prepetition priority tax claims over a period of about six years. It further provided that these payments would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the taxes (Pet. App. 5a). The government objected to the designation provision on the same grounds that it raised in *Energy Resources*. Pet. App. 4a-5a.

b. The bankruptcy court overruled the government's objection (Pet. App. 42a-50a). The court declined to adopt respondent's broad contention that tax payments under a Chapter 11 plan are always subject to designation by the debtor because there is no "enforced collection measure" that makes them involuntary (see *id.* at 45a-46a). Instead, the court concluded that whether a Chapter 11 debtor may designate its tax payments should be decided on a case-by-case basis according to the "totality of the facts and circumstances" (*id.* at 47a (citation omitted)).[3] The court expressed concern that, if payments of priority taxes in Chapter 11 cases were always held to be involuntary, it "would remove the initiative of [the debtor's] former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan" (*id.* at 48a). The court concluded that the existence of third-party financing constituted "special circumstances" that justified including the trustee's requested designation provision in the plan here (*ibid.* (citation omitted)).

c. Ruling from the bench, the district court reversed and ordered the bankruptcy court to delete the designation provision from the reorganization plan (Pet. App. 27a-30a). Adopting the reasoning of the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987), the court stated that the policies of reorganization and collecting taxes were intended by Congress to "work together" so as to avoid a "double-whammy" loss in taxes to the government – namely, by allowing responsible officers to

[3] The court listed several factors that it regarded as relevant to this analysis, including: (1) the history of the debtor; (2) whether the IRS had taken any pre-bankruptcy collection measures; (3) the nature of the Chapter 11 plan; (4) the extent of administrative or court action; and (5) the "existence of exceptional or special circumstances warranting [the] allocation provided by the plan." Pet. App. 47a n.7.

escape Section 6672 liability while the government is required to credit employees with taxes withheld by their employer, but not paid over to the government (see Pet. App. 28a-29a). The court concluded that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (*id.* at 29a-30a).

3. On consolidated appeals, the court of appeals affirmed in the *Energy Resources* case and reversed in the *Newport Offshore* case (Pet. App. 1a-23a). The court stated that, in accord with the Third Circuit in *Ribs-R-Us*, it "believe[d] that the law permits the IRS to call tax payments within a Chapter 11 reorganization 'involuntary,' for purposes of applying its own regulations" (*id.* at 6a). The court explained that whether payments made pursuant to a Chapter 11 reorganization plan should be characterized as "voluntary" or "involuntary" depends upon the degree of control the bankruptcy court has over the payments at issue, and it found that a Chapter 11 proceeding exhibits some characteristics that are "voluntary" and others that are "involuntary." Recognizing the deference due the IRS's interpretation on this matter, the court declared that it accepted the view that payments made pursuant to a Chapter 11 plan are "involuntary." *Id.* at 7a-12a. The court ruled, however, that this conclusion was not dispositive because it "only means • • • that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue" (*id.* at 12a).

The court of appeals then proceeded to hold that the bankruptcy courts are empowered to require the IRS to apply the tax payments first to the trust fund tax liability. The court of appeals viewed the governing question as (Pet. App. 12a-13a): "Does a bankruptcy court possess the

legal power to order the IRS to apply a payment in a way that runs *counter* to IRS's own internal policies?" The court listed several factors it considered significant in concluding that bankruptcy courts do have power to override the IRS's traditional authority to apply involuntary tax payments as it chooses.

First and foremost, the court stated that "Congress has granted bankruptcy courts broad equitable powers" (Pet. App. 13a). In particular, the court pointed to the bankruptcy court's power to " 'issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions' of the Bankruptcy Code" (*ibid.*, quoting 11 U.S.C. 105 (emphasis by the court)). As an example of when "an order allocating Chapter 11 tax payments to 'trust fund' liabilities first would seem 'appropriate,' " the court posited the situation where the responsible officers offer to help rehabilitate the debtor by advancing funds, but "only if the court would assure them that the reorganized corporation would pay its 'trust fund' tax debts first" (Pet. App. 13a-14a). In that situation, the court reasoned, the bankruptcy court could determine that it should direct the IRS to apply the payment in accordance with the officers' demand on the theory that the diminished chances that the government would collect its entire tax debt would be outweighed by the increased chances that the debtor would "pay something to its general unsecured creditors" (*id.* at 14a).

In the court's view, the other factors that it listed buttressed this conclusion regarding the bankruptcy court's power. The court stated that bankruptcy courts have long had power to tell creditors how to apply payments against the debtor's several debts (Pet. App. 14a-15a) and that nothing in the Bankruptcy Code limits the bankruptcy court's designation power when the creditor is the IRS (*id.* at 15a-16a). The court reasoned that "it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of

Chapter 11 tax payments" because it is equipped to consider the effect of that determination on the debtor's prospects for rehabilitation and it already has the power to structure the timing of tax payments within the six-year constraint of 11 U.S.C. 1129 (Pet. App. 16a).

The court further noted that the IRS's policy of allocating payments first to non-trust fund taxes, while clearly calculated to maximize the collection of delinquent taxes, is not compelled by a statutory directive (Pet. App. 16a-17a). Finally, the court stated that it could "find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here" (*id.* at 17a). In particular, the court stated that the strong congressional policy of ensuring the collection of trust fund taxes embodied in 26 U.S.C. 6672 would not be undermined by its decision because the designation provided for the collection of trust fund taxes first, albeit at the expense of non-trust fund taxes that would go unpaid if the reorganization failed, whereas the IRS's allocation postponed the collection of trust fund taxes (Pet. App. 17a-20a). Suggesting that the policy of Section 6672 is "simply to check off the tax liabilities in [the government's] 'trust fund' books" as quickly as possible (*id.* at 19a), the court declared that "the IRS's argument seems to stand the policy of Section 6672 on its head" (*id.* at 18a).

Accordingly, the court of appeals concluded that the bankruptcy courts are empowered to order the allocation of involuntary tax payments in Chapter 11 proceedings. The court held that the allocation question should be determined by the bankruptcy court on a case-by-case basis, subject to review under the clearly erroneous standard. Pet. App. 21a. And the court specified the following as the appropriate inquiry (*ibid.*): "upon consideration

of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money?" The court concluded that it was unnecessary to remand the cases, holding that the bankruptcy courts' opinions indicated that they both would have upheld the requested designations under the foregoing standard (*id.* at 21a-23a).

SUMMARY OF ARGUMENT

A. 1. Section 6672 of the Internal Revenue Code (26 U.S.C.) is designed to protect against the misappropriation of taxes required to be withheld by employers and other third parties and then held "in trust for" (26 U.S.C. 7501) and paid over to the government. Under this provision, persons responsible for remitting these funds to the government who willfully fail to do so are individually liable for the amount of the unpaid "trust fund" taxes. Section 6672 liability acts as a deterrent to corporate officers who might be tempted to convert these trust funds to private use. It also protects the revenue by providing an additional source of collection when the trust fund taxes are not paid.

2. The IRS has long followed the policy of allowing taxpayers to designate how voluntary payments should be allocated among their various debts, but, in the case of involuntary payments, of allocating a partial payment as the IRS sees fit. When the IRS receives an involuntary payment from a taxpayer who owes both trust fund and non-trust fund taxes, it generally will apply that payment first to the non-trust fund liability, so as to preserve the alter-

nate source of collection in the event the corporation does not fully satisfy its liabilities. The IRS has applied this policy in the context of priority tax payments made pursuant to a Chapter 11 plan of reorganization; in doing so, the IRS has rebuffed the efforts of corporate debtors to designate the payments for application first to their trust fund liability—for the purpose of eliminating the Section 6672 liability of their responsible persons as quickly as possible.

The courts of appeals generally have agreed with the IRS's rejection of these designation requests, recognizing that priority tax payments pursuant to a Chapter 11 plan are "involuntary." By filing for protection under Chapter 11, the debtor gives up his freedom to deal with his property as he chooses; instead, the debtor must abide by the restrictions imposed by the Bankruptcy Code for the protection of creditors. In particular, the Bankruptcy Code requires as a condition of confirmation of the reorganization plan that all priority taxes be paid within six years of assessment (11 U.S.C. 1129(a)(9)(C)); if that condition, or other prerequisites to confirmation, cannot be met, the bankruptcy court must dismiss the Chapter 11 proceedings or liquidate the corporation (11 U.S.C. 1112(b)). Thus, the corporate debtor's payment of priority taxes essentially is made under threat of liquidation and in accordance with a reorganization plan with which the bankruptcy court has the power to order compliance. Accordingly, the payment cannot properly be regarded as "voluntary."

The ability of the IRS to reject the debtor's designation request in the Chapter 11 context is important to effectuating the policies underlying Section 6672. The requested designation would operate to prevent the government from protecting itself by applying corporate tax payments first to the non-trust fund liabilities, for which there is no separate source of collection. If the reorganization does not succeed, the government would then have to

bear the loss of the unpaid non-trust fund taxes. Thus, the designation would shift the risk of failure of the reorganization from the responsible officers, whose misconduct created the trust fund delinquencies in the first place, to the government. Moreover, if responsible officers had reason to believe they could ultimately escape Section 6672 liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable, the disincentive to plunder the trust fund to aid the struggling corporation would be greatly reduced. Thus, requiring the IRS to abide by a corporate debtor's designation of Chapter 11 payments would weaken the corporation's incentive to pay its taxes voluntarily, rob Section 6672 of much of its effectiveness, and directly undermine the Commissioner's ability to maximize the collection of delinquent taxes.

B. 1. Although the court of appeals accepted the IRS's characterization of priority tax payments under a Chapter 11 plan as involuntary, and therefore did not dispute that the IRS is not required to honor the debtor's designation, the court erred in holding that the bankruptcy court nevertheless is empowered to direct the IRS to honor a designation that such payments first be applied to trust fund liabilities. Contrary to the court's suggestion (Pet. App. 14a), there is no authority for the proposition that bankruptcy courts have inherent power to implement general equitable principles by directing creditors how to apportion partial payments. Nor does the Bankruptcy Code confer such wide-ranging authority on bankruptcy courts.

No provision in the Bankruptcy Code expressly grants this power, and the court of appeals erred in reading such an authorization into 11 U.S.C. 105. That general provision speaks to the procedural powers of the court, permitting it to implement the substantive provisions of the Bankruptcy Code by issuing equitable orders such as injunctions and stays. Section 105, however, "does not au-

thorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986) (footnote omitted)).

Although the Bankruptcy Code provides many opportunities for debtors to reorganize, rather than liquidate, it does not establish rehabilitation of the debtor as an unqualified goal. In particular, Congress has determined that payment of delinquent priority taxes must take precedence over rehabilitation, and that a debtor cannot proceed with a reorganization plan unless it provides for full payment of priority taxes. Therefore, the bankruptcy court's power to enter orders necessary to implement the provisions of the Bankruptcy Code plainly does not give it unbridled authority to enter any order that would facilitate rehabilitation. The court cannot upset the balance carefully established by Congress by ordering the IRS to make an allocation designed to advance the interests of general creditors at the acknowledged expense of the government's ability to collect priority taxes.

2. The court of appeals' decision would also undermine the policies reflected in Section 6672, which are critical to the integrity of the withholding tax system. Congress has recognized that allowing a responsible person to avoid his Section 6672 liability in bankruptcy proceedings would vitiate that provision's effectiveness as a deterrent and as an alternate source of collection. Accordingly, Section 6672 liabilities are given priority and are nondischargeable in a responsible officer's personal bankruptcy proceeding. It is not appropriate for the bankruptcy court to allow the same officer—through the threat of noncooperation with the corporate debtor's reorganization—to achieve in the corporate reorganization proceeding the personal relief not available in his own bankruptcy proceeding. The court of appeals' rule would similarly undermine the deterrent value of Section 6672. Thus, the decision below would frustrate the congressional design embodied in both Section 6672 and the Bankruptcy Code to deter the conversion of trust funds to personal use and to protect the Treasury against loss from such misappropriations.

ARGUMENT

THE GOVERNMENT IS NOT REQUIRED TO APPLY PRIORITY TAX PAYMENTS RECEIVED UNDER A CHAPTER 11 PLAN FIRST TO THE DEBTOR'S TRUST FUND TAX LIABILITY

Under Section 6672 of the Internal Revenue Code (26 U.S.C.), corporate officers responsible for remitting federal taxes that have been withheld by an employer from the wages of its employees are personally liable for the amount of these "trust fund" taxes that they fail to turn over to the government. This provision reflects the fact that these funds are not the property of the corporation; to the contrary, these funds are held in trust for the government. Section 6672 operates to deter responsible persons from converting these funds for private use and to provide an alternate source for collection of the withheld taxes in the event that the funds are so converted. The court of appeals in this case has substantially weakened the practical effect of Section 6672 by allowing responsible officers who convert trust funds to private use to manipulate corporate bankruptcy proceedings to reduce or eliminate their individual liability—at the acknowledged expense of the government's ability to collect its delinquent taxes from the corporate debtor.

The court of appeals held that a bankruptcy court has discretion to allow a corporate debtor in Chapter 11 proceedings to designate priority federal tax payments under its reorganization plan for application first to its trust

fund tax liability. The practical effect of such a designation is that payments of priority taxes under Chapter 11 plans redound first to the benefit of responsible corporate officers, not to the government; if the reorganization plan is not successfully completed, the government is left with an uncollectible non-trust fund tax claim, while the corporate officers have been relieved of their trust fund liability to the extent tax payments have been made. As an example of the circumstances in which it would be appropriate for a court to so exercise its discretion, the court of appeals posited the situation in which the responsible officers require such a designation provision as a condition of their cooperation with the reorganization. Thus, the decision below allows corporate officers to plunder the government's trust fund for private use and then, after the funds have disappeared and the corporation has gone bankrupt, to use the threat of noncooperation with the reorganization to have scarce corporate resources applied first to annul their separate liability for trust fund taxes, rather than to satisfy the corporation's other delinquent tax liabilities. There is no authority vested in the bankruptcy court to effect this untoward result, which undermines the congressional design embodied in both Section 6672 and the Bankruptcy Code.

A. The Government Is Not Obligated To Honor A Corporate Debtor's Request That Its Priority Tax Payments Under A Chapter 11 Plan Be Applied First To Trust Fund Tax Liability

1. Congress has determined that several kinds of taxes, notably the employee's portion of social security tax and employee income tax, should be collected by a third party and then paid over to the government (see 26 U.S.C. 3102, 3402).[4] Although employers are required by law to

[4] Other taxes of this type include income taxes on certain sweepstakes or gambling winnings (26 U.S.C. 3402(q)(1)) and excise taxes on communication services and transportation by air (26 U.S.C. 4291).

hold these collected funds as "a special fund in trust for the United States" (26 U.S.C. 7501), Congress recognized that corporate employers might be tempted to use these funds for private purposes and then fail to turn them over to the government. See *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978). These trust fund delinquencies have a serious effect on the Treasury because the employees must be credited with payment of the withheld amounts as if the trust funds were in fact remitted to the government. See 26 U.S.C. 31(a); *Slodov* v. *United States*, 436 U.S. 238, 243 (1978). As a result, the government may be required to issue refunds to these employees or to distribute social security benefits to them, based upon tax payments that were never received by the government.

To protect against the danger of misappropriation of trust fund taxes, Congress enacted what is now 26 U.S.C. 6672, imposing personal liability in an amount equal to the unpaid trust fund taxes upon responsible persons who willfully fail to collect and remit these taxes to the government.[5] This provision aids the collection of trust fund taxes in two ways. First, the specter of personal liability acts as a deterrent to the corporate officers who might be tempted to use the withheld amounts for operation of the corporation; thus, the prospect of Section 6672 liability helps "to assure compliance by the employer with its ob-

[5] Section 6672 provides that "[a]ny person required to collect * * * and pay over any tax * * * who willfully fails to collect such tax, or truthfully account for and pay over such tax, * * * shall * * * be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over." This imposition of personal liability dates back to the earliest years of the federal income tax. See *Slodov* v. *United States*, 436 U.S. at 248 n.10.

ligation to withhold and pay the sums withheld" (*Slodov* v. *United States*, 436 U.S. at 247). Second, in cases where the responsible persons nonetheless fail to pay over withheld taxes, Section 6672 provides an "additional source for collection" so that the government does not necessarily suffer a loss if it cannot collect from the corporation. See, *e.g.*, *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (6th Cir. 1988); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987).

Although the individual's liability under Section 6672 is separate and distinct from that of the corporation, it is the longstanding policy of the IRS not to retain payments that exceed the amount of unpaid trust fund taxes. This policy accords with the congressional goal underlying Section 6672 to guarantee collection of withholding taxes. Thus, the liability may be collected in part from one or more responsible persons and in part from the corporate employer, or it may be collected entirely from one of those sources, but the IRS will not seek to do more than make itself whole for the withheld amounts that it must credit to the employees' accounts. See *United States* v. *Sotelo*, 436 U.S. at 279 n.12; *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 & n.7 (5th Cir. 1986); Policy Statement P-5-60 (approved May 30, 1984, and its predecessor approved June 2, 1977), *Policies of the Internal Revenue Service Handbook*, [1 Administration] Internal Revenue Manual (CCH), at 1305-14 (Mar. 1989).[6] As a

[6] As a general rule, the IRS will seek to collect from the corporation before proceeding against the responsible persons. The IRS is not required, however, to exhaust its remedies against the corporation before it attempts to collect from the responsible persons. Thus, it is no defense to the imposition of Section 6672 liability that the taxes might still be collected from the corporation or the assets of its bankruptcy estate. See *Calderone* v. *United States*, 799 F.2d 254, 257-258 (6th Cir. 1986).

result, the responsible person's Section 6672 liability is reduced *pro tanto* by corporate payments of delinquent trust fund taxes.

For this reason, where a corporation owes both trust fund and non-trust fund taxes, it is in the government's fiscal interest to apply a partial payment to the non-trust fund liability—thereby preserving the alternate source of collection for the trust fund portion of the liability in the event the corporation cannot make full payment. Accordingly, when the IRS is determining how to allocate such a partial payment, its policy generally is to apply it first to non-trust fund taxes due the government. See, *e.g.*, *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 201 (3d Cir. 1987); *United States* v. *DeBeradinis*, 395 F. Supp. 944, 952 (D. Conn. 1975), aff'd, 538 F.2d 315 (2d Cir. 1976) (Table) (if he failed to apply funds first to non-trust fund liabilities, the Commissioner would "shirk his responsibility to insure that the maximum amount of assessed tax be collected").

2. It is a well settled rule of common law that a debtor has authority to direct his creditor how to apply a partial payment voluntarily made. If the debtor does not make such a designation, then the creditor can apply the partial payment as he sees fit. See, *e.g.*, *National Bank of the Commonwealth* v. *Mechanics' Nat'l Bank*, 94 U.S. 437 (1876); *Field* v. *Holland*, 10 U.S. (6 Cranch) 8, 27 (1810). It is also well established that when the debtor makes the payment involuntarily, he has no right to direct the allocation of the payment among his various debts. See generally 70 C.J.S. *Payment* § 37 (1987); 60 Am. Jur. 2d *Payment* § 103 (1987). In line with these principles, the IRS has long distinguished between voluntary and involuntary payments in ascertaining when it has power to determine which outstanding tax liabilities are satisfied by particular payments. The IRS permits taxpayers to designate the application of "voluntary" tax payments, but "involuntary"

payments are applied according to the IRS's own determination. See, *e.g.*, *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966); Rev. Rul. 73-304, 1973-2 C.B. 42; Rev. Rul. 73-305, 1973-2 C.B. 43, modified by Rev. Rul. 79-284, 1979-2 C.B. 83; Rev. Rul. 58-239, 1958-1 C.B. 94.[7]

This policy encourages taxpayers to make voluntary payments, thereby sparing the government the expense of pursuing collection by administrative levy or in judicial proceedings. See *Amos* v. *Commissioner*, 47 T.C. at 70. And in the trust fund context in particular, this policy encourages responsible persons to resist the temptation to raid the government's trust funds to pay other business expenses when a corporation is in financial distress. If they instead pay the amount of the withheld taxes voluntarily, the responsible persons can avoid personal liability by designating the payment for application to the trust fund liability. The IRS's policy of designating the application of involuntary tax payments generally has not been disputed, and it has been regarded as "uniformly followed by the courts" (*Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983)). See also *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *Amos* v. *Commissioner*, 47 T.C. at 69-70.

Applying this established policy, the Commissioner has taken the position that a corporate debtor may not designate the application of its priority tax payments under a Chapter 11 plan because such payments are "involuntary," and that position has been upheld by the courts of appeals. See *DuCharmes & Co.* v. *Michigan*, 852

[7] An involuntary payment for these purposes traditionally has been defined as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor" (*Amos* v. *Commissioner*, 47 T.C. at 69).

F.2d 194 (6th Cir. 1988); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987); *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987); but see *United States* v. *A & B Heating and Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), vacated, 108 S. Ct. 1724 (1988), on remand, 861 F.2d 1538, 1539-1540 (11th Cir. 1988), further opinion, 878 F.2d 1311 (11th Cir. 1989). When a bankruptcy petition is filed, the debtor receives the protection of an automatic stay and other benefits, but in exchange it assumes significant limitations on its freedom of action. As the Third Circuit observed, "[d]ebtors who file under *any* chapter of the bankruptcy code have few, if any, options" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203 (internal quotation omitted)). Upon filing a petition for relief under the Bankruptcy Code, the debtor's property, as well as subsequently acquired property, becomes the property of the bankruptcy estate. 11 U.S.C. 541(a). The bankruptcy trustee, or the debtor in possession if a trustee is not appointed, holds this property in trust for the benefit of creditors. Therefore, he cannot deal with the property solely for the advantage of the debtor, but rather is bound to respect the priorities and other restrictions imposed by the Bankruptcy Code for the protection of creditors. See generally 11 U.S.C. 1106, 1107; S. Rep. No. 989, 95th Cong., 2d Sess. 116 (1978); *Wolf* v. *Weinstein*, 372 U.S. 633, 649-650 (1963); *In re* [illegible]. *Technical Knockout Graphics, Inc.*, 833 F.2d at 802-803; *In re Ribs-R-Us, Inc.*, 828 F.2d at 202-203.

Once there is a confirmed Chapter 11 plan of reorganization, the debtor does not have the option to decline to pay priority taxes. Section 1129(a)(9)(C) of the Bankruptcy Code establishes as a condition for confirmation of the reorganization plan that it provide for payment by the debtor of all seventh priority taxes within six years from the date of assessment. Although the debtor or trustee has

some degree of " 'latitude' as to 'how and when the IRS will be paid' " (Pet. App. 11a (quoting *In re Lifescape, Inc.*, 54 Bankr. 526, 528 (Bankr. Colo. 1985)), it remains an absolute requirement that the plan propose to pay priority taxes in full on terms at least as favorable as those specified in Section 1129(a)(9)(C). See *In re Ribs-R-Us, Inc.*, 828 F.2d at 203 & n.3. In short, a corporate debtor pays its priority taxes under a Chapter 11 plan of reorganization because it is compelled to do so as a condition of the reorganization. Furthermore, if a feasible reorganization plan that complies with statutory requirements cannot be developed, the Chapter 11 proceedings must be either dismissed or converted to Chapter 7 liquidation proceedings. 11 U.S.C. 1112(b). Thus, the corporate debtor's payment of priority taxes essentially is made under threat of liquidation; that payment cannot reasonably be regarded as "voluntary."

Moreover, the considerable extent of judicial involvement in a Chapter 11 proceeding makes the payment of priority taxes under a reorganization plan closely akin to a payment pursuant to a judgment in a collection suit, which is unquestionably an involuntary payment. The bankruptcy court has authority to determine the amount of the debtor's tax obligations (11 U.S.C. 505), which in turn determines the amount of payments under the plan that must be set aside for delinquent priority taxes; moreover, the court is obligated to reject any proposed plan that falls short of the statutory requirement for payment of priority taxes (11 U.S.C. 1129(a)(9)(C)). Once the court confirms the plan, it has the power to compel compliance (11 U.S.C. 105(a), 1142). Thus, the confirmed plan is the equivalent of a court order requiring the debtor to pay its creditors according to a specified schedule. See *In re Ribs-R-Us, Inc.*, 828 F.2d at 203. In short, once a debtor decides to avail itself of the protection of Chapter 11 and submits itself to the jurisdiction of the bankruptcy court

for that purpose, it has no choice but to pay its priority tax obligations; a characterization of such payments as "voluntary" cannot be reconciled with the realities of the debtor's situation and the restrictions imposed by the Bankruptcy Code.

In addition, payments made pursuant to a Chapter 11 plan fall within the traditional definition of involuntary payments and the general policies that counsel against allowing a taxpayer to designate such payments. To collect its priority taxes in bankruptcy, the IRS, at a minimum, is required to file claims and to monitor the bankruptcy proceedings. Thus, when it receives taxes by means of payments under Chapter 11, the government is not spared the expense of collection, as it is with a genuine voluntary payment, which merely is posted to the taxpayer's account. And the payment of a priority tax claim pursuant to a Chapter 11 plan confirmed by the bankruptcy court meets the recognized definition of an involuntary payment; it is received "from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor" (*Amos* v. *Commissioner*, 47 T.C. at 69).

The policies that underlie Section 6672 and the IRS's practice of declining to allow taxpayers to designate involuntary tax payments for application first to trust fund tax liability are strongly implicated in the Chapter 11 context. A corporate debtor's ability to designate its Chapter 11 tax payments in this manner would substantially erode the protection afforded the public fisc by Section 6672 at a time when that protection is most critical—namely, when the corporation is so beset by financial difficulties that it must seek relief in the bankruptcy courts. Although Section 6672 is designed to assist the government in the collection of tax delinquencies, the designation provision would have the opposite effect. The government would be unable to protect itself by applying the corporate tax payments to the corporation's non-trust fund tax liabilities, while at

the same time retaining the ability to collect unpaid trust fund delinquencies from the persons responsible for creating the delinquencies. In the event the reorganization is not successful and the corporate tax liability is not paid in full, the government could not resort to the responsible persons to make itself whole, but would have to bear the loss of the priority taxes that the corporate debtor did not pay. In effect, the designation would shift the risk of failure of the plan from the responsible officers, whose improper conduct created the trust fund delinquency, to the government.

In addition to undermining the efficacy of the alternate source of collection established by Section 6672, allowing the corporate debtor to designate its Chapter 11 payments would greatly weaken the disincentive for the responsible persons to create the trust fund tax delinquency in the first place. If the responsible persons have reason to believe that they ultimately can escape Section 6672 liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable, the statute will not deter them from using the trust fund in a last-ditch effort to save a failing corporation. Moreover, the responsible persons would have little incentive to satisfy trust fund deficiencies prior to bankruptcy if they retain the power to designate, as if made voluntarily, payments made only as required by statute as a condition of the confirmation of a reorganization plan. Thus, requiring the IRS to abide by the corporate debtor's designation of Chapter 11 payments would weaken the corporation's incentive to pay its taxes voluntarily, rob Section 6672 of much of its effectiveness, and directly harm the Commissioner's ability to maximize the collection of delinquent taxes. Accordingly, as the courts of appeals have held, the established rule regarding the apportionment of involuntary tax payments should be applied to permit the IRS to allocate priority tax payments

under a Chapter 11 plan as it sees fit, without regard to the corporate debtor's request that the payments be applied first to trust fund liabilities.

B. The Bankruptcy Court Lacks Authority To Direct The IRS To Apply A Corporate Debtor's Chapter 11 Tax Payments So As To Minimize The Responsible Persons' Section 6672 Liability At The Expense Of The Government's Ability To Maximize The Collection Of Delinquent Taxes

The court of appeals expressed no disagreement with the principles discussed above or with their application to this case. The court did not question the IRS's established practice of allocating involuntary tax payments among various outstanding delinquencies as the IRS determines is appropriate (see Pet. App. 7a-9a). The court also "accept[ed] [the IRS's] view" that priority tax payments under a Chapter 11 reorganization plan are "involuntary" (*id.* at 12a). Thus, the court of appeals agreed that the IRS is not required to honor a corporate debtor's designation of its Chapter 11 priority tax payments. The court held, however, that the *bankruptcy court* has authority to direct the IRS how to apply the debtor's tax payments, and that it can order the IRS to apply those payments to minimize the Section 6672 liability of the responsible officers, notwithstanding the detrimental effect on the public fisc, if it believes that such an allocation will contribute to the prospects for a successful reorganization that will benefit unsecured creditors. This holding is erroneous.

1. Citing *National Bank of the Commonwealth* v. *Mechanics' Nat'l Bank, supra,* the court of appeals stated that "bankruptcy courts have long had the legal power to tell creditors against which of a debtor's several debts they are to apply a particular payment" (Pet. App. 14a). This broad statement simply cannot be supported. Nothing in this Court's decision in *National Bank of the Common-*

wealth suggests that a bankruptcy court can direct a creditor how to apply a partial payment among several debts having equal priority. The statement by this Court relied upon by the court of appeals is no more than an almost verbatim restatement of the rule—noted by this Court in several earlier cases[8]—that allocation of a voluntary payment may be directed in the first instance by the debtor or, if he fails to designate an allocation, by the creditor; only if neither party exercises its right to allocate the payment does the authority to do so devolve upon the court.[9]

Indeed, the decision in *National Bank of the Commonwealth* has no bearing at all on the issue addressed by the court of appeals. First, as in the earlier cases cited there, the Court in *National Bank of the Commonwealth* appears to address only the question of voluntary payments;[10] that certainly is how the case generally has been understood by lower courts. See, *e.g.*, *S.S. Silberblatt, Inc.* v. *United States*, 353 F.2d 545, 548 & n.9 (5th Cir. 1965); *Jung* v. *United States*, 701 F. Supp. 175,

[8] See *United States* v. *Kirkpatrick*, 22 U.S. (9 Wheat.) 720, 737-738 (1824); *United States* v. *January*, 11 U.S. (7 Cranch) 572, 574-575 (1813); *Field* v. *Holland*, 10 U.S. (6 Cranch) at 27.

[9] This Court stated the rule as follows (94 U.S. at 439):

> The rule settled by this court as to the application of payment is, that the debtor or party paying the money may, if he chooses to do so, direct its appropriation; if he fail, the right devolves upon the creditor; if he fail, the law will make the application according to its own notions of justice.

[10] The payments in *National Bank of the Commonwealth* had been made by a receiver, rather than by the debtor itself. 94 U.S. at 437. But there is no indication that the payments in question were regarded by the Court as any less voluntary than a payment by a solvent debtor; certainly they were not compelled by any statute akin to 11 U.S.C. 1129(a)(9)(C).

176 (E.D. Wis. 1988). Second, the Court in *National Bank of the Commonwealth* did not approve a court-sanctioned allocation that would override the wishes of one of the parties; to the contrary, the Court merely approved the designation made by the debtor. See 94 U.S. at 439. In fact, the Court specifically noted that it "need not * * * consider" what would be an appropriate allocation if it were the duty of the court to make the allocation (*ibid.*).[11]

To the extent these early cases cast any light on a court's authority to designate payments, they suggest that the equitable considerations invoked by the court below do

[11] The legal encyclopedia cited by the court of appeals (Pet. App. 14a) also provides scant support for its broad assertion of bankruptcy court authority. First, that source recognizes a "split of authority" concerning the power of a court to override a creditor's designation of an involuntary payment; the quotation relied upon by the court of appeals thus does not reflect a consensus view. See 60 Am. Jur. 2d *Payment* § 103, at 949 (1987). Moreover, that quotation suggests that any power that a court holds in this regard is confined by the "rights and priorities" of creditors established by statute. *Ibid.* In any event, the same source recognizes that the courts have uniformly approved the IRS's policy of designating involuntary *tax* payments (*id.* § 104), and it does not suggest that this policy is called into question by its more general observations concerning the power of courts to allocate non-tax payments. See also *O'Dell* v. *United States*, 326 F.2d at 456 (court has no power to direct IRS how to apply involuntary payment); *Amos* v. *Commissioner*, 47 T.C. at 68-70 & n.3 (same). *Commercial Credit Corp.* v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955) (cited at Pet. App. 13a), also lends no support to the decision below. In that case, the IRS apparently had allocated the proceeds of a judicial sale to a tax debt secured by a lien that was *junior* to that of the plaintiff, and therefore the IRS's action was inconsistent with the priority rules that govern distributions from judicial sales. In the instant case, by contrast, the IRS proposes to apply the Chapter 11 payments only to seventh priority tax claims, and therefore the IRS's allocation is fully consistent with the priorities established in the Bankruptcy Code.

not support its decision. In *Field* v. *Holland*, 10 U.S. (6 Cranch) at 28, the Court approved the allocation that had been made in that case, stating that "[i]t being equitable, that the whole debt should be paid, it cannot be inequitable, to extinguish first those debts for which the security is most precarious." Thus, the decision below (requiring the IRS to reduce its chances for total recovery by applying Chapter 11 payments first to those liabilities for which there is an alternate source of collection) is at odds with this Court's expressed view of an equitable allocation of a partial payment to a creditor when the various debts are not equally well secured.

2. There is no provision in the Bankruptcy Code or elsewhere that expressly confers upon the bankruptcy court authority to direct the IRS to apply Chapter 11 priority tax payments first to trust fund liability. The court of appeals held, however, that Congress has conferred "broad equitable powers" upon the bankruptcy courts that authorize them to require the IRS to honor the debtor's requested designation (Pet. App. 13a). This interpretation cannot be sustained. Rather, as the Third Circuit stated, "no provision in the Bankruptcy Code allows either the debtor or the bankruptcy court to direct application of payments and thereby preclude recourse by the United States against responsible parties who serve as guarantors of the United States' claims against the employer" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204).

The court of appeals cited 11 U.S.C. 105(a) as the source of this broad equitable power. That provision empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." In the court of appeals' view, if the responsible officers of the corporate debtor refuse to aid the reorganization unless the priority tax payments under the plan are applied so as to minimize their Section

6672 liability, it is "appropriate"—and hence authorized by Section 105—for a bankruptcy court to direct the IRS to apply Chapter 11 payments first to trust fund tax debts. The court explained that this designation would be proper, even though it concededly would reduce the government's chances of collecting its entire tax debt, because the responsible officers' assistance would help "keep[] the firm alive" and therefore increase the possibility that unsecured creditors ultimately will recover some of the money owed to them. See Pet. App. 13a-14a.

The court of appeals' assertion of bankruptcy court authority rests on a serious misinterpretation of Section 105. That provision does not confer upon the bankruptcy courts unbridled authority to enter any order that would aid the rehabilitation of the debtor. Section 105 of the Bankruptcy Code speaks to the procedural powers of the bankruptcy court. The statute was designed to extend to bankruptcy courts the powers exercised by other courts under authority of the All Writs Act, 28 U.S.C. 1651, as well as other powers traditionally exercised by bankruptcy courts under the old Bankruptcy Act. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 316-317 (1977).[13] Thus, "Section 105(a) simply authorizes a bankruptcy court to fashion such orders as are necessary to further the purposes of the substantive provisions of the Bankruptcy

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[13] Except for two specific changes not relevant here, Congress noted that Section 105 was derived from Section 2(a)(15) of the old Bankruptcy Act, 11 U.S.C. 11(a)(15) (1976), which was even more clearly addressed only to the procedural powers of the court. See H.R. Rep. No. 595, *supra*, at 316-317; 2 L. King, *Collier on Bankruptcy* ¶ 105.01 (15th ed. 1989). That Section provided in pertinent part that bankruptcy courts could "[m]ake such orders, issue such process, and enter such judgments * * * as may be necessary for the enforcement of the provisions of this Act."

Code" (*United States* v. *Sutton*, 786 F.2d 1305, 1307 (5th Cir. 1986) (footnote omitted)). The equitable powers conferred on the bankruptcy courts by Section 105 are to issue orders such as injunctions and stays and to punish contempt in cases where such orders are necessary to implement the substantive provisions enacted by Congress. *Ibid.*; *Bird* v. *Carl's Grocery Co.*, 864 F.2d 593, 595 (8th Cir. 1989).

Section 105, however, "does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d at 1308 (footnote omitted)). See also *Browning* v. *Navarro*, 887 F.2d 553, 559 (5th Cir. 1989); *Bird* v. *Carl's Grocery Co.*, 864 F.2d at 595; *Johnson* v. *First Nat'l Bank*, 719 F.2d 270, 274 (8th Cir. 1983), cert. denied, 465 U.S. 1012 (1984). Rather, the scope of Section 105 is limited; "its broad equitable powers may only be used to further the policies and provisions of the [Bankruptcy] Code" (*Bird* v. *Carl's Grocery Co.*, 864 F.2d at 595). See also *In re* ▪. *Technical Knockout Graphics, Inc.*, 833 F.2d at 803; *Official Committee of Equity Security Holders* v. *Mabey*, 832 F.2d 299, 302 (4th Cir. 1987), cert. denied, 485 U.S. 962 (1988). As this Court stated in another context, "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code" (*Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988)).

To the extent the court of appeals sought to rest its holding upon a substantive determination by Congress embodied in the Bankruptcy Code, as opposed to a court's generalized notions of equity, it suggested that ordering the IRS to designate priority tax payments so as to minimize the Section 6672 liability of responsible persons furthers "the Bankruptcy Code's preference for rehabilitation over liquidation" (Pet. App. 20a). Although rehabilitation is an important and worthy goal, that goal must be pursued only within the limitations established by the Code that address other, often competing, interests. Therefore, an order cannot be said to be "necessary or appropriate to carry out the provisions of [the Bankruptcy Code]" (11 U.S.C. 105) solely because it may in some fashion increase the likelihood that the debtor will be rehabilitated.[13]

One of the major interests competing with the goal of rehabilitation that Congress weighed in enacting the Bankruptcy Code is the government's interest in the collection of delinquent taxes. Congress recognized that the government often bears the brunt of a failing business's inability to pay all of its creditors (H.R. Rep. No. 595, *supra*, at 193):

> In business cases, * * * it is a frequent occurrence that the business will stop paying its taxes before it stops paying its other creditors, because the officers of the business know that detection of nonpayment is more difficult for the taxing authority than it is for a supplier or lender, and that an unpaid supplier quickly

[13] The Bankruptcy Code does not "constitute a guarantee that all persons who seek reorganization protection under the Code will qualify for it" (*Success Tool & Mfg. Co.* v. *United States Dep't of Treasury*, 62 Bankr. 221, 224 (N.D. Ill. 1986)). A debtor seeking to reorganize under the protection of Chapter 11 must meet the prerequisites established by Congress. See, *e.g.*, 11 U.S.C. 109, 1123, 1129. If the debtor is unable to do so, the bankruptcy court is not empowered to enter orders to help the debtor to reorganize at the expense of the statutory requirements. To the contrary, if the debtor is unable to propose or effectuate a confirmable reorganization plan (*i.e.*, a plan that satisfies the conditions imposed by Congress), the bankruptcy court is obligated to dismiss the Chapter 11 proceeding or to convert it into a liquidation proceeding. See 11 U.S.C. 1112(b).

> stops shipping goods, though an unpaid taxing authority is usually unable to take collection action for months.

See also *id.* at 189-190. Accordingly, Congress acted to protect the revenue in bankruptcy proceedings by providing a priority for specified tax claims, including those at issue in this case, and by making those tax debts nondischargeable. See 11 U.S.C. 507(a)(7), 523(a)(1)(A). Hence, the observation made by this Court about the old Bankruptcy Act is equally applicable today; there has been a "congressional judgment that certain problems—*e.g.*, those of financing government—override the value of giving the debtor a wholly fresh start" (*Bruning* v. *United States*, 376 U.S. 358, 361 (1964)).

The court of appeals also adverted (Pet. App. 15a-16a) to the explicit recognition in the legislative history that the Bankruptcy Code requires a balancing between the competing interests of the debtor, the general creditors, and the taxing authorities. See S. Rep. No. 989, 95th Cong., 2d Sess. 13-14 (1978). But the court of appeals erred in relying upon this general statement to justify its decision here. The Senate Report proceeds to specify the manner in which Congress determined to balance those competing interests—namely, by giving some tax debts priority and making them nondischargeable and by denying that preferred status to other tax debts. See S. Rep. No. 989, *supra*, at 14; see also *United States* v. *Gurwitch*, 794 F.2d 584, 585-586 (11th Cir. 1986) (there is a "clear policy judgment by Congress" favoring collection of priority taxes over the debtor's rehabilitation). Thus, to the extent that dismissal of the Chapter 11 proceedings or a conversion to liquidation would cause general unsecured creditors to go unpaid, while allowing priority taxes to be collected from

available funds, that result is deliberately mandated by Congress.[14]

There is no suggestion that Congress thought it appropriate to deviate from this priority scheme by conferring upon the bankruptcy court the power to designate tax payments, to the detriment of the IRS's ability to collect delinquent taxes, in order to entice responsible persons to release claims against the debtor or to cooperate in obtaining financing. It is undoubtedly true that the success of a reorganization may be jeopardized if the debtor's officers are, for whatever reason, unwilling to cooperate fully in the reorganization. But that does not give the bankruptcy court carte blanche to enter orders designed to secure such cooperation by assisting the officers at the expense of another party to the bankruptcy. The bankruptcy court must accept the manner in which Congress has balanced the competing interests in bankruptcy; it cannot upset that balance by ordering the IRS to make an allocation designed to advance, at the government's expense, the interests of general creditors (see Pet. App. 14a).

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[14] The discussion in the Senate Report marked by the ellipsis in the court of appeals' quotation (Pet. App. 15a) is highly relevant, since it emphasizes and explains the importance that Congress attached to the satisfaction of delinquent tax claims in bankruptcy. The Report states (S. Rep. No. 989, *supra*, at 14):

> [T]ax collection rules for bankruptcy cases have a direct impact on the integrity of the Federal, State and local tax systems. These tax systems, generally based on voluntary assessment, work to the extent that the majority of taxpayers think they are fair. This presumption of fairness is an asset which should be protected and not jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoiding their tax debts. To the extent that debtors in a bankruptcy are freed from paying their tax liabilities, the burden of making up the revenues thus lost must be shifted to other taxpayers.

3. In addition to its departure from Congress's carefully considered balancing of interests in the Bankruptcy Code, the decision below would substantially undermine congressional policies embodied in the Internal Revenue Code. A bankruptcy court's designation of priority tax payments for application first to the corporation's trust fund liabilities is directly "in derogation of Congress' strong policy, reflected in Section 6672, to protect the government's tax revenues by insuring an additional source from which trust fund taxes can be collected" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 204). As we have discussed (pp. 17-18, 31-32, *supra*), Congress recognized the danger that officers of struggling businesses could be tempted to use withheld tax funds in an attempt to ease temporarily their financial difficulties.[15] Therefore, the personal liability imposed by Section 6672 for failure to remit trust funds to the government is critical to the integrity of the withholding tax system, in that it provides a deterrent to the conversion of trust funds and an alternate source of collection if they are misused.

Clearly, the deterrent effect of Section 6672 and its value as an alternate source of collection would be greatly diminished if a responsible person could raid the trust fund and then nonetheless avoid his individual liability for the unpaid taxes through bankruptcy proceedings. Accordingly, Congress generally has been careful to preserve

[15] See also *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978) (quoting Marsh, *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 Wash. L. Rev. 681, 694 (1967)): "It is a common phenomenon of business failure that even an 'honest' businessman, in attempting to salvage a business which appears headed for insolvency, will frequently 'borrow' money of other people without their consent if he can get his hands on it. The one fund which he is almost always able to lay his hands on is the taxes he has withheld and is currently withholding from his employees for the Government."

the efficacy of the Section 6672 protection in its bankruptcy legislation. For example, Section 6672 liability is given priority and is not dischargeable in a responsible officer's personal bankruptcy proceeding. See 11 U.S.C. 507(a)(7)(C), 523(a)(1); *United States* v. *Sotelo*, 436 U.S. at 275-280 (Bankruptcy Act). This rule was designed to address the Treasury Department's specific concern that it is "most undesirable to permit persons who are charged with the responsibility of paying over to the Federal Government moneys collected from third persons to be relieved of their obligations in bankruptcy when they have converted such moneys for their own use" (*id.* at 276 (quoting S. Rep. No. 114, 89th Cong., 1st Sess. 10 (1965)). Compare *Kelly* v. *Robinson*, 479 U.S. 36 (1986).

Against this background, the district court in *Newport Offshore* is surely correct in stating that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (Pet. App. 29a-30a). It is not appropriate for the bankruptcy court to permit the same officers—through the threat of noncooperation with the corporate debtor's reorganization—to achieve personal relief in the corporate bankruptcy proceedings that they could not obtain in their own bankruptcy proceedings.[16]

[16] The courts have consistently rejected the attempts of responsible persons to use corporate bankruptcy proceedings to shield themselves from Section 6672 liability. A bankruptcy court presiding over corporate bankruptcy proceedings may not enjoin the assessment or collection of the Section 6672 liabilities of the debtor's responsible persons. See *LaSalle Rolling Mills, Inc.* v. *United States*, 832 F.2d 390 (7th Cir. 1987); *A to Z Welding and Mfg. Co.* v. *United States*, 803 F.2d 932, 933 (8th Cir. 1986); *United States* v. *Huckabee Auto Co.*, 783 F.2d 1546, 1548 (11th Cir. 1986). The courts have also held that the government is not required to exhaust its remedies against the cor-

Moreover, this Court has held that a court generally may not require the United States to take into account the interests of sureties or guarantors in deciding how to allocate partial payment of a debt due to it; rather, the United States is free to make the allocation in its own fiscal interest even if that allocation perpetuates the third party's potential liability. *Jones* v. *United States*, 48 U.S. (7 How.) 681, 688, 691-692 (1849); *United States* v. *Giles*, 13 U.S. (9 Cranch) 212, 241 (1815); see also 60 Am. Jur. 2d *Payment* § 126 (1987). Even if the rule were otherwise for sureties that are blameless and only secondarily liable, it would seem clear that an officer subject to Section 6672 liability—who breached the statutory trust and whose liability is not secondary, but rather is distinct from that of the corporation—should not be entitled to relief from liability by forcing the IRS to apply the corporation's partial payment against the government's fiscal interest.

There can be little doubt that permitting the bankruptcy court to order designation of Chapter 11 tax payments first to trust fund taxes would seriously undermine Section 6672. The value of the provision as a deterrent to the conversion of trust funds in the first place would manifestly be weakened if the responsible officers had reason to believe they could ultimately escape personal liability under cover of Chapter 11. And, contrary to the suggestion of the court of appeals (Pet. App. 18a-20a), the designation orders approved here also would undermine the value of Section 6672 as a guarantee for collection of

porate debtor before making a Section 6672 assessment against a responsible person. See, *e.g.*, *Calderone* v. *United States*, 799 F.2d 254, 257-258 (6th Cir. 1986); *Hornsby* v. *IRS*, 588 F.2d 952, 954 (5th Cir. 1979). And a responsible person who has paid his Section 6672 liability has no right to reimbursement or contribution from the corporate debtor. *Levit* v. *Ingersoll Rand Financial Corp.*, 874 F.2d 1186, 1191-1192 (7th Cir. 1989).

delinquent trust fund taxes. To be sure, the designation would mean that the trust fund tax liability would be eliminated on the IRS's books sooner than if the Chapter 11 payments are applied first to non-trust fund taxes. But the revenue protection policy of Section 6672 is not designed to achieve an accounting goal of assuring that tax dollars collected will be placed in the trust fund column, rather than the non-trust fund column. Rather, the statute is intended to protect the Treasury from a loss—by providing an alternate source of collection from the persons responsible for misusing the funds held in trust for the government.

Under the court of appeals' decision, Section 6672 would no longer protect the Treasury from a loss. As the court of appeals acknowledged (Pet. App. 20a), dollars are "fungible," and there is therefore no reason for Congress or the Treasury to prefer the collection of a dollar of trust fund liability over a dollar of non-trust fund liability. As the court of appeals also acknowledged (*id.* at 14a), its designation policy would actually decrease the likelihood that the Treasury will collect the delinquent taxes because it would postpone collection of the unguaranteed non-trust fund taxes, putting that debt at risk that the reorganization plan will not be successfully completed.[17]

[17] This forced postponement of the collection of the non-trust fund liability is particularly inappropriate in light of the fact that funds withheld for the collection of taxes are required to be held in trust for the government and thus should never become the property of the corporation. In recognition of this special status, the Bankruptcy Code provides that withheld taxes still in the debtor's possession are not even included in the property of the estate that is available to be used in the reorganization. See 11 U.S.C. 541(d). Thus, it is only because the responsible persons here not only failed to pay over the trust funds to the government, but also dissipated the trust fund itself, that satisfaction of the trust fund liability has become a matter that must

Thus, while it is technically true that the designation would not reduce the collection of *trust fund taxes*, that collection would be accomplished only by, in effect, substituting another pocket of the Treasury (its non-trust fund taxes) in place of the guarantors established by Congress in Section 6672—the persons responsible for the creation of the trust fund delinquency. It would thus frustrate the intent of Section 6672 to require the government to collect its trust fund taxes at the expense of the other taxes owed to it (a shortfall that Congress recognized would ultimately be borne by other taxpayers (see note 14, *supra*))—for the express purpose of relieving the corporation's responsible persons of the liability imposed on them by Section 6672.[18] There is, in sum, no proper authority for the bankruptcy court to require a designation that is so inimical to the congressional design embodied in both the Bankruptcy Code and the Internal Revenue Code.

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be addressed by the Chapter 11 plan. If the responsible persons' malfeasance had been less extreme, the only priority tax payments to be made under the plan would have been those of the non-trust fund taxes, which the bankruptcy court would have no reason to postpone until the end of the reorganization.

[18] As we explained in our reply at the petition stage (at 3-5), the court of appeals erred in suggesting (Pet. App. 20a) that the government can protect itself from loss by seeking to collect from the responsible persons as quickly as possible. Quite apart from the fact that this approach would appear to defeat the court of appeals' professed goal of encouraging those persons to cooperate with the reorganization, this approach would not adequately protect the government's tax collection prospects. Even if Section 6672 liability is assessed against the responsible person, he can delay its collection by paying a small portion of the claimed liability, posting a bond, and then filing a claim for refund—thereby allowing the designation provision to operate to eliminate his separate liability. Moreover, even if the trust fund delinquency is collected from him, the responsible person still has a considerable period within which to seek a refund, during which time the designation provision will continue in force.

CONCLUSION

The judgments of the court of appeals should be reversed.

Respectfully submitted.

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IN THE

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UNITED STATES OF AMERICA,
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vs.
ENERGY RESOURCES CO., INC.,

UNITED STATES OF AMERICA,
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vs.
NEWPORT OFFSHORE, LTD.,

ON WRITS OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

BRIEF OF GLK, INC. AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR GLK, INC., AMICUS CURIAE

STATEMENT OF INTEREST

GLK, Inc. is a debtor operating under a plan of reorganization approved by the Bankruptcy Court for the

Central District of California. GLK's plan contained a provision which, like that of Newport Offshore Ltd., provided that payments to the Internal Revenue Service be applied first to reduce its liability for "trust fund" taxes. That provision was ordered stricken by the court which felt compelled to follow the opinion of the Ninth Circuit Court of Appeals in *In re Technical Knockout Graphics*, 833 F.2d 797 (9th Cir. 1987), which held that payments to the Internal Revenue Service by a Chapter 11 debtor prior to confirmation of its plan of reorganization were "involuntary" and that therefore neither the debtor nor the court could direct how such payments should be applied. The Bankruptcy Court's order was appealed to the Bankruptcy Appellate Panel, affirmed, and is currently the subject of an appeal pending with the Ninth Circuit Court of Appeals in *In re GLK, Inc.*, No. 89-55196 (9th Cir.).

All parties have consented to the filing of this brief and letters indicating such consent have been filed with the Clerk.

SUMMARY OF ARGUMENT

Recent disputes over the allocation of tax payments have focused on whether the payments should be labelled "voluntary" or "involuntary" because of the *assumed* validity of a rule allowing tax debtors to designate application of "voluntary" payments and the Internal Revenue Service ("I.R.S.") to apply "involuntary" payments as it chooses. Courts have *incorrectly assumed* without question that such a dichotomy reflected the common law rule. As a result, there has been consistent heated litigation over the labelling question in the Chapter 11 bankruptcy context. Below, the First Circuit Court of Appeals accepted the I.R.S.'s use of the "voluntary-involuntary dichotomy" for purposes of its own

rules, but held that the courts were not bound by those rules and could order the I.R.S. to follow the designation made by the debtor.

The "voluntary-involuntary dichotomy" does *not* reflect the common law of this country. Instead it is a distortion of the longstanding and workable common law rules. The dichotomy should be laid to rest and the common law rules should be properly revived.

Under common law rules applied for over 100 years, debtors have had the right to designate how payments are to be applied among two or more debts owed to the same creditor. The right to make the allocation devolves upon the creditor only if, when and to the extent the creditor receives the payment unencumbered by any allocation. When and to the extent courts become vested with control over a debtor's property, the court has the authority to make such allocation according to its notions of justice. Although the terms "voluntary" and "involuntary" were used to describe payments, neither debtors *nor* creditors had the right to control application of payments described as "involuntary," in which case the right devolved upon the court having control of the property. Under those common law principles, the labelling question contributes nothing to an allocation dispute between debtor and creditor. The critical determinant underlying the allocation rules has been the property right of control and extent to which a debtor has been divested of that property right of control over the money or property. The right to designate how a debtor's property will be applied, being in the nature of "control" over the property, has followed the other property rights of that debtor. The ability of a taxpayer to designate how payments to the I.R.S. are to be applied as among various tax debts is rooted in the same common law. No special tax law or policy abrogates the common law rules or tax debtors' rights in that regard.

In a Chapter 11 bankruptcy, a debtor in possession retains practical control over its property, subject to court review. Upon confirmation of a plan of reorganization, all assets are vested back in the debtor, subject to his compliance with the plan. There is no legitimate reason or authority for denying reorganized debtors the ability to exercise a long-standing common law right and giving it to the I.R.S. If, under some theory, a debtor loses his "control" right to designate the application of his funds in bankruptcy, that right would be lost or surrendered to the court and/or any trustee, not the creditors. Likewise any allocation of tax payments would then be made by the court or trustee, not the I.R.S. as creditor. Thus, the bankruptcy court order requiring I.R.S. application of tax payments as designated by the debtors was proper and should be upheld, although based on a different analytical approach.

The imposition of personal liability on responsible corporate officers for unpaid trust fund taxes under the Internal Revenue Code does not reflect a policy inconsistent with a debtor's exercise of longstanding common law rights. The I.R.S. perceived potential for debtors abusing that right does not warrant abolishing it, especially when its exercise is already subject to judicial scrutiny in the Chapter 11 context. The policy suggested by the imposition of liability on responsible officers is that trust fund taxes be collected above all else, and it is those very taxes which the debtors here seek to pay, not avoid. Thus the substantive exercise of the debtors' rights here is entirely consistent with the policies reflected in the statute and should be upheld.

ARGUMENT

I RECENT DECISIONS ADDRESSING THE ISSUE OF PAYMENT APPLICATIONS IN THE TAXATION CONTEXT HAVE UNWITTINGLY APPLIED THE WRONG RULE OF LAW. THE I.R.S. NOW URGES THIS COURT TO DO THE SAME.

Recent disputes over whether the taxpayer/debtor or the Internal Revenue Service ("I.R.S.") has the right and authority to designate how payments to the I.R.S. will be applied among tax debts when made by a debtor in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C.) have primarily focused on whether the payments should be labelled "voluntary" or "involuntary." That focus is the result of the unquestioned application of an I.R.S. "rule" that "permits taxpayers to designate the application of 'voluntary' tax payments, but [that] 'involuntary' payments are applied according to the I.R.S.'s own determination." Brief for Petitioner [United States/I.R.S.] at 19-20. That "rule" (that a debtor may designate how "voluntary" payments are to be applied, and that the I.R.S. is free to apply "involuntary" payments as it wishes) is referred to in this brief as the "voluntary-involuntary dichotomy," or sometimes as the "dichotomy." Below, the I.R.S. claimed that the dichotomy reflects the common law policy, however, the Court of Appeals did not question that claim. *Energy Resources*, 871 F.2d at 227. Despite the fact that the dichotomy neither reflects the common law rule nor is generally recognized outside the taxation context, no court has questioned its validity or the propriety of its application. *See, e.g., In re DuCharmes & Company*, 852 F.2d 194,

196 (6th Cir. 1988), ("...payments made to the I.R.S. on pre-petition tax liabilities by a Chapter 11 debtor ought to be considered 'involuntary payments' that may not be allocated [by the debtor]..."), *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 201 (3d Cir. 1987), ("Ribs-R-Us does not challenge the proposition that its entitlement to designate payments depends on whether we view the payments as voluntary."), *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797, 801 (9th Cir. 1987), ("The issue here is whether payment of taxes after the debtor has filed a petition for reorganization under Chapter 11, but prior to confirmation of the reorganization plan, is voluntary.").

Below, the First Circuit Court of Appeals similarly accepted the validity of the dichotomy and its application by the I.R.S. when applying its own regulations, but further held that bankruptcy courts have the authority to order the I.R.S. to apply payments in a manner inconsistent with the I.R.S. proposed allocation. *In re Energy Resources Co., Inc.*, 871 F.2d 223 (1st Cir. 1989).

The "voluntary-involuntary dichotomy" does *not* reflect the long-standing common law rules and is not the proper rule to apply at all. By applying the dichotomy, the I.R.S. usurps power and authority neither recognized by the common law for creditors generally nor granted it specifically by statute.

II THE APPLICABLE COMMON LAW VESTS THE RIGHT TO DIRECT PAYMENT APPLICATION IN THE PERSON WHO CONTROLS THE FUNDS AT THE TIME OF PAYMENT. SINCE NOTHING IN THE BANKRUPTCY CODE OR THE INTERNAL REVENUE CODE SHIFTS THAT RIGHT TO THE I.R.S., THE COURT BELOW CORRECTLY AFFIRMED THE BANKRUPTCY COURT ORDERS THAT THE I.R.S. FOLLOW THE DEBTOR DESIGNATIONS.

A. Historical rules grant debtors the right to designate how payments are to be applied among debts. Under the common law, a debtor's right to designate how payments will be applied among debts is lost only when the money or property is lost. When control over property is surrendered by a debtor to the court, the right to designate the application of that property likewise devolves upon the court, not the creditor.

The general rule of law in this Country regarding application of payments is well settled that:

> "... the debtor or party paying the money may, if he chooses to do so, direct its appropriation; if he fail, the right devolves upon the creditor; if he fail, the law will make the application according to its own notions of justice. Neither of the parties can make it after a controversy upon the subject has arisen between them, and *a fortiori* not at the trial."

National Bank of the Commonwealth v. Mechanics' National Bank, 94 U.S. 437, 439 (1876), citing *United States v. Kirkpatrick*, 22 U.S. (9 Wheat.) 720 (1824), *United States v. January*, 11 U.S. (7 Cranch) 572 (1813), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810). *See also*, *First Nat. Bank in Palm Beach v. United States*, 591 F.2d 1143, 1147 (5th Cir. 1979), citing, among other authorities, *Tayloe v. Sandiford*, 20 U.S. (7 Wheat.) 7, 9-

10 (1822). The applicability or logic of the general rule has not been questioned in any relevant decision.

The logic and justice of the traditional rule is rooted in the simple right to control one's own property. *See, e.g., Bank of California v. Webb*, 94 N.Y. 467, 472 (1884), where the court stated:

> "A debtor paying money to a creditor to whom he owes several debts may direct the application of the payment because the money is his and he may do as he will with it and control its application. But the debtor must exercise his option as to the application when he makes the payment. After that the money has ceased to be his and is no longer subject to his control. Then it belongs to the creditor, and he is master of it, and may control its application... But if neither party makes any application of the payment and the matter comes into court, then the court will make such application of the payment as equity and justice require."

See, also, 40 AM. JUR. *Payment* §110 at p. 792. The rule's roots in the concept of control continue to be recognized in recent cases. *See, e.g., Federal Land Bank v. Wilson*, 719 F.2d 1367, 1371 (8th Cir. 1983), ("A debtor desiring to avail himself of his right to direct the application of a payment must give the direction therefor either before or at the time of payment; otherwise, the right is lost, because thereafter the money ceases to be his, and is no longer subject to his control.").

The use of terms regarding volition in this context is not new. However that use neither reflects nor supports application of the voluntary-involuntary dichotomy used by the I.R.S. and applied without question in recent decisions. Under early authorities, the creditor's right to designate how payments would be applied upon the debtor's failure to do so was as dependent on so-called

"voluntary" payments as was the debtor's right. *See, e.g.*, 40 AM. JUR. *Payment* §109 at p. 791 and §111 at p. 793, citing *Orleans County Nat. Bank v. Moore*, 112 N.Y. 543, 20 N.E. 357 (1889) for the proposition that "[t]he right of a debtor to make an application of a payment, or, in the event of his failure to do so, the right of a creditor to make such an application, may be exercised only in cases of voluntary payment." Thus, the labelling question, considered so important in recent disputes, contributes nothing to the analysis suggested by traditional wisdom.

Later works continued to recognize and describe the limitation on application of payments by both debtors and creditors, saying "In [cases involving involuntary payments, such as resulting from execution or judicial sales,] neither the debtor nor the creditor has a right to make an application..." 70 C.J.S. *Payment* §37 at p. 33, citing *Safe Deposit & Trust Co. v. Woodbridge*, 184 Md. 560, 42 A.2d 231 (1945), which itself relied upon *Orleans County Nat. Bank v. Moore*. *See also*, 60 AM. JUR.2D *Payment* §103, p. 948, which cites *Orleans County Nat. Bank v. Moore, First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977), and *Safe Deposit & Trust Co. v. Woodbridge*, both of the last two of which themselves rely on the first. Since *Orleans County Nat. Bank v. Moore* appears, directly or indirectly at the foundation of references to volition, an analysis of that case is appropriate to determine the significance of volition in this context.

Orleans County Nat. Bank v. Moore involved the right of a creditor to apply as it wished the proceeds of a judicial foreclosure sale among three separate obligations secured by a mortgage. The defendant Moore was secondarily liable on two of the three obligations. The court held that the application of the payments was to be made by the court, not the creditor, saying:

> " The right of a creditor to apply a payment made to him by a debtor, in the absence of any application by the debtor, seems to be confined to cases of voluntary payments. [citation omitted]...
> " So, in this case, if the mortgagor, by the condition in the mortgage, did not make an application of the moneys which might arise from a sale of the mortgaged premises to any particular debt, such moneys having arisen from a foreclosure and sale of the premises, and coming into the hands of the plaintiff (through the sheriff) by reason thereof, and in a judicial proceeding, their application would properly be made by the court, and upon equitable principles." *Orleans County Nat. Bank v. Moore*, 20 N.E. at 359.

The debtor's lack of volition precluded any creditor right to apply the payment as well as any debtor right. It is apparent that the term "voluntary" was not used as a criterion for debtor application, but to describe the presence of control. The essence of control as the true determinant is further underscored by the court's reference to a note on the cases of *Mayor et al. v. Patten*, 8 U.S. (4 Cranch) 317 (1807), and *Field v. Holland*, 10 U.S. (6 Cranch) 8 (1810), expressing that:

> "... the general principle of the common law is that the ownership of money determines the right of appropriation; and after it is paid, the debtor can make none." *Orleans County Nat. Bank v. Moore*, 20 N.E. at 364.

The Court went on to say:

> "It would seem that in cases of payment *in invitum*, or by judicial proceedings, the creditor does not become the owner of the money until it is paid, and the law at the very time of the payment

> makes its own application, and the creditor has no opportunity to make it himself."

Id. The above statement has been accepted as a proper description of the common law. *See*, 40 AM.JUR. *Payment*. §139 at p. 811 (citing *Orleans County Nat. Bank v. Moore*). The logic is clear and consistent: the property (and the concomitant right of control over it) was divested from the debtor in the foreclosure action and subjected to the jurisdiction (and therefore control) of the court. The issue decided was how the court would exercise its control in allocating the payment. After reviewing both English and American authorities, the court exercised its discretion and applied the monies *pro rata* among all three debts.

That the common law rule is alive outside the context of taxation is evident from its modern application; for example, by a Federal district court's application of non-tax payments previously made under bankruptcy court order. *First Nat. City Bank v. Kline*, 439 F.Supp. 726 (S.D.N.Y. 1977). There, a bank sought payment from a guarantor of one of several debts owed to it by a bankrupt debtor. Pursuant to the bankruptcy (apparently a liquidation), an undesignated part payment had been made to the bank. In the action on the guaranty, one of the guarantor's defenses was that the part payment received by the bank should have been applied to the guaranteed debt. The bank, in a position analogous to that of the I.R.S. here, took a contra position. The court held that "[w]here, as here, moneys are repaid under judicial order, the court has exclusive authority to apply the funds, and its application must be structured as "equity and justice require." *Id.* at 729, citing *Bank of California v. Webb*, 94 N.Y. 467, 472 (1884) and *Orleans County Nat. Bank v. Moore*, 112 N.Y. at 548, 20 N.E. at 359. The court went on to apply the payment *pro rata* among all the debts.

The voluntary-involuntary dichotomy, which gives creditors the automatic right to determine the application of payments to which the "involuntary" label is attached, is *not* a product of the longstanding common law.

The question then is whether the common law rule was intentionally abandoned by the courts and replaced by the dichotomy with respect to the payment of tax liabilities by a debtor, either in general, or specifically when those payments are made in the context of a bankruptcy reorganization.

B. Reliance on a "voluntary-involuntary dichotomy" in tax cases was the result of unintentional misapplications, not abrogation, of the traditional rules.

When the issue of application of payments was presented to the courts in the context of taxation, the courts naturally and properly looked to the same common law rules.[1]

In *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), the Court of Appeals held that the bankruptcy court lacked jurisdiction to direct the I.R.S. how to apply monies deposited with the court but not belonging to the bankrupt estate. In *O'Dell*, excess proceeds realized from a Sheriff's foreclosure sale of real property owned jointly by the bankrupt and his wife and not in the bankrupt's estate, as well as monies realized by the I.R.S. after seizure and sale of another parcel of realty, also not in the bankrupt's estate, were deposited into the

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[1] No statute preempts the common law regarding application of payments or authorizes the I.R.S. to promulgate regulations which would curtail a tax debtor's otherwise existing rights.

bankruptcy court upon its order. On denying a motion of the bankrupt's wife that the impounded money be paid over to the I.R.S. only after certain assets of the bankrupt estate were used to satisfy a portion of the tax debt and then only to the extent of the penalty owing, the bankruptcy court ordered the money turned over to the I.R.S. and ruled that the funds were not an asset of the bankrupt estate and that it lacked jurisdiction to compel any specific allocation of the proceeds. That result appears correct under the common law rules if viewed as a refusal by the court to exercise control over property not properly deposited with it. On appeal, the Tenth Circuit Court of Appeals affirmed the bankruptcy court, but used reasoning appearing inconsistent both internally and with the authorities relied upon. The Court of Appeals there reasoned that the jurisdiction of the bankruptcy court over the funds was proper since the parties had invoked and consented to it. The court then addressed the application issue, saying:

> "As a general rule, a debtor voluntarily paying his debt may direct application of his money to such items or demands as he chooses. 70 C.J.S., Payment, § 52, pp. 257-259; 40 Am.Jur., Payment, § 110, pp. 792-793. But, such is not the case where, as here, the payment is made involuntarily as in an execution or judicial sale. 70 C.J.S., Payment, § 51, pp. 256-257; 40 Am.Jur., Payment, § 139, pp. 811-812."

Id. at 456. The Court quoted only *part* of the common law rule and therefore wrongly expressed and interpreted it. As previously discussed, C.J.S. and AM. JUR. both relied upon *Orleans Nat. Bank v. Moore* for the proposition cited and all three authorities clearly express that, in the case of "involuntary" payments, it is *neither* the debtor *nor the creditor*, but indeed *is* the court, to properly determine application of the payments made

under its order. Having determined that the exercise of the bankruptcy court's jurisdiction over the monies was proper, the very authorities cited by the Court suggest that the Court was under a duty to apply the monies in accordance with equitable principles.[2]

A few years later, the Tax Court, in *Amos v. Commissioner*, 47 T.C. 65 (1966), held that amounts received by the I.R.S. pursuant to administrative levies could be applied between assessments of tax, penalties and interest as the I.R.S. chose. The Tax Court acknowledged the general rule as well as the historical limitations to its application, saying, with respect to the latter:

> "In many jurisdictions, including Illinois where these payments were made, it is held that the rule giving the debtor or creditor the right to direct the application of *voluntary* payments has no application to *involuntary* payments." *Id.* at 68 [emphasis by court].

In a footnote, the court recognized a critical distinction between the "involuntary" exception to the general rule and the case of an administrative levy then before it, saying:

> "Usually cases applying [the rule denying the debtor and *creditor* the right to direct the application of involuntary payments] involve judicial proceedings, such as bankruptcy, receivership, probate, or mortgage and lien foreclosures, in which the sale of property is under the umbrella of the court's supervision. In such situations the

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[2] Another possible and reasonable theory for the result reached could have been a declination of the Court to make an allocation in the exercise of its discretion, *i.e.*, to intentionally allow the payment to be made unallocated. Such was not the reasoning of the Court, however.

> court, in its discretion, determines the application of payments according to legal and equitable principles. There is no court supervision or control over payments received by a district director as a result of administrative collection of Federal taxes by levy or distraint." *Id.* at 68 & n. 3. [emphasis added].

The *Amos* Court did recognize the significance of control and acknowledged court-directed application of court-controlled funds.

Applying the historical common law approach and analysis of control, the court's decision was appropriate and consistent with traditional reasoning. From the time of the levy, the taxpayer/debtor lost control of, and therefore the right to designate the application of proceeds from, the property seized or levied upon. There being no court involvement or other intermediary exercising legitimate control over the property or funds, the right of control and concomitant right to direct application devolved upon the I.R.S.

The *Amos* Court's discussion was not without some confusion, however. It appears that the confusion stemmed at least in part, from the *O'Dell* decision, which the court recognized as an aberration. The *Amos* Court mentioned a "minority view" that "some jurisdictions give the creditor the right to direct the application of involuntary as well as voluntary payments." *Amos* at 69. Recognizing (but not so stating) that the *O'Dell* recitation of the general rule was incorrect, the Court suggested that the *O'Dell* court had "adopted" the minority view with respect to taxes. Clearly, however, that was not the case. To that time, *no* rule, including the "minority view," gave debtors discretion in the application of voluntary payments and creditors unfettered discretion in the application of "involuntary" payments. As previously discussed, the *O'Dell* discussion was a misguided or

incomplete attempt to apply the traditional "majority" rule. Possibly as a result of not being entirely comfortable relying solely on *O'Dell*, the *Amos* Court also claimed support for its conclusion from *Standard Oil Co. v. United States*, 5 F.Supp 976 (Ct.Cl. 1934), *cert. den.*, 293 U.S. 599, and *Matter of Griffitts Paving Co., Inc.*, 54-2 U.S.T.C. ¶9646 (E.D. Tenn. 1954). Those two cases were (and are here), however, inapposite. Those cases primarily involved the issue of the I.R.S.'s right to apply overpayments in one or more years to deficiencies in one or more other years under statutory authority. The issue there presented was one of statutory construction and Congressional intent, rather than the applicability and application of the common law. Unfortunately, the *Amos* Court failed to realize that all the support it needed was available in the longstanding common law rules.

Application of the rules in the context of tax cases was further explored in *Muntwyler v. United States*, 703 F.2d 1031 (7th Cir. 1983). In *Muntwyler*, the I.R.S. filed a claim for trust fund and non-trust fund taxes with a non-judicial trustee/assignee for the benefit of the taxpayer/debtor's creditors. The trustee made payments to the I.R.S. directing their application to trust fund taxes. The I.R.S. accepted the money, but refused to honor the direction regarding application of it. The district court upheld the allocation, finding the *assignee's* payment "voluntary." The Seventh Circuit also applied the "voluntary-involuntary dichotomy," but again to the *assignee's* payment, stating:

> "The sole question, therefore, is whether the district court correctly held that the assignee's payment was voluntary." *Id.* at 1033.

The I.R.S. argued that the payment was involuntary (presumably as to the *debtor*) because it was made pursuant to an I.R.S. administrative claim filed with a

third party assignee, relying on language in *Amos*. The court disagreed, however, saying:

> "The distinction between a voluntary and involuntary payment in *Amos* and all other cases is... the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy." *Id.* at 1033. [emphasis by the court].

The Court there enlisted support for its conclusions from the I.R.S.'s own Policy Statement P-5-60, Int. Rev. Manual (CCH) 1305-15, that taxpayers have "no right of designation in the case of collections resulting from *enforced collection measures*." [emphasis added by court in quoting Policy Statement]. The court held that "merely filing a claim for back taxes [was not] an 'enforced collection measure.'" *Muntwyler*, 703 F.2d at 1032. Again, the significance of the "seizure" language appears to be the clear transfer of control over the seized property resulting from such action.

It is significant that while all prior cases applying the "voluntary-involuntary dichotomy" examined the *taxpayer's* volition, here the court focused on and was persuaded by I.R.S. action or inaction, *i.e.*, by the absence of a *seizure* by the I.R.S., noting that the only action of the I.R.S. was to file a claim.

Common law analysis takes a different path to the same result and also suggests the analytical deficiencies which have, over the years, produced so much litigation over the same or similar issues arising in the Chapter 11 bankruptcy context. Upon its assignment to the trustee, the *Muntwyler* debtor lost control over his property and with it the right to designate how the trustee's payments would be applied. The payment was, in a sense, "involuntary" as to the taxpayer. Thus, there was some logic in the I.R.S. argument to that effect. Control, however, vested in the trustee, not the I.R.S. The trustee/as-

signee, therefore, having title to and control over the property (albeit subject to his duties as assignee for the benefit of creditors), had the legal right and power to direct application of payments made. It was necessarily the latter fact of assignee control, rather than the former fact of the debtor's loss of control, that the court focused on (in saying that the *assignee's* payment was voluntary) and which lead to the result. By understanding, acknowledging and applying the traditional rules, the same appropriate result could have been reached without the laborious inquiry concerning volition. Although couched in terms of volition, the issue has always been one of the simple property right of "control."

C. Attempts to apply the Voluntary-Involuntary Dichotomy in the Chapter 11 Context have resulted in an unworkable game of semantics.

The voluntary-involuntary dichotomy is not only inconsistent with the analytically sound common law rules and any logical evolution therefrom, it doesn't work.

Insistence that remittances be classified in one of only two ways, each having rigid and opposite results and implications, fails to allow the law sufficient flexibility to work justice and is neither required by statute nor consistent with the historically applied common law rules. The terms "voluntary" and "involuntary," themselves subjective terms to begin with, are, under the dichotomy, elevated from descriptive labels to determinative criteria, and legal reasoning has been precluded or reduced to a semantical game.

The semantic nature of the voluntary-involuntary dichotomy can be demonstrated as follows. Certain

payments, such as those made in the context of a Chapter 11 proceeding, are not clearly "voluntary" or "involuntary," having some characteristics generally found in situations described by each term. Courts have analyzed and weighed the various attributes of the Chapter 11 context in attempts to "fit" the "right" label. *See, In re Energy Resources, Co., Inc.*, 871 F.2d at 228-229. Since a payment in such a "gray area" will have characteristics of both the agreeably "voluntary" and the agreeably "involuntary," one could answer "no" to the question "is the payment voluntary?" (thereby calling it "involuntary"); but could also answer "no" to the converse (concluding it to be "voluntary"). Thus, in applying the voluntary-involuntary dichotomy to payments falling within the "gray area," whether such payments are considered voluntary or involuntary will depend more on how one couches the question and the subjective evaluation of definitional characteristics than on any substantive distinctions in reason, logic and justice which the law, presumably, seeks to make. Payments made in the Chapter 11 bankruptcy context fall within that "gray area" and therefore fall victim to the faulty analysis inherent in the dichotomy. Both the First Circuit below and the Ninth Circuit in *Technical Knockout Graphics* noted the struggle over fitting the dichotomy's labels and the resulting split in the circuits. *In re Energy Resources, Co., Inc.*, 871 F.2d at 229, *Technical Knockout Graphics*, 833 F.2d at 801-802. To the extent the courts have relied on the voluntary-involuntary dichotomy as a "simplified," "bright-line" rule for determining the right to direct application of tax payments, the rule has proved neither simple and bright nor just and efficacious.

In struggling over which of only two allowable labels a given remittance should be given ("voluntary" or "involuntary") so as to decide whether the taxpayer or the I.R.S. can direct its application, the dichotomy fails

to recognize (as the common law did) that the ability to direct application of payments does not *have* to lie solely and exclusively within the whim of either of two litigants. By focusing on two labels rather than on control over property, the dichotomy ignores that there are interim points on the voluntary-involuntary continuum and there is a necessary and proper role for courts in determining just application of payments among liabilities when such payments are made pursuant to court order or under court supervision.

In applying the dichotomy, Courts have resolved the immediate disputes but not the real issue. The opportunity is now presented to return to the analytically sound common law rules.

D. Nothing in the Bankruptcy Code divests debtors in a Chapter 11 reorganization, of their common law right to designate the application of payments. If there is such a divestiture, the ability to designate rests with the court, not the creditor (I.R.S.).

Upon commencement of their Chapter 11 proceedings, estates comprised of all the debtors' respective property and rights therein were created. 11 U.S.C. §541. The Bankruptcy Court acquired jurisdiction over all such property. 28 U.S.C. §1334(d). As debtor in possession, Newport Offshore acquired or retained all rights and interests in its property, subject to its duties as provided by law, its plan of reorganization, and to the Court's jurisdiction; the ERCO Liquidation Trust acquired all rights and interests in Energy Resources Co., Inc.'s property subject to similar duties and jurisdiction. 11 U.S.C. §1107(a). Newport Offshore and the ERCO Liquidation Trust were, as a result, in positions

similar to that of the *Muntwyler* debtor and assignee, combined.

No provision of the law divested either Newport Offshore or the ERCO Liquidation Trust of its common law right to designate how payments made to creditors would be applied. Although the exercise of that right may have been subject to review by the bankruptcy court, under no reasonable theory was the right to designate the application of payments automatically divested from either debtor and passed to the I.R.S. as creditor. There is no basis for a creditor's rights in this regard to be any greater in the bankruptcy context than outside it.

The law requires that any proposed plan of reorganization meet certain requirements and make certain provisions. 11 U.S.C. §1123. The debtors' plans met those requirements. A plan may, however, also contain "any other appropriate provision not inconsistent with the applicable provisions of [Title 11]." 11 U.S.C. §1123(b)(5). If a debtor's plan meets the requirements of the law, the Court is required to confirm it. 11 U.S.C. §1129(a) and (b)(1). Thus, the Court is given specific authority to review and confirm plans with provisions designating how payments to creditors should be applied if they otherwise meet the statutory requirements. There was nothing improper in the Court's approval of Newport Offshore's plan.

Upon confirmation of their respective plans, all property of the Energy Resources Co., Inc. estate, including all rights and interests therein, was vested in the ERCO Liquidation trust, subject only to the terms and conditions of the trust and the plan, and all property rights of Newport Offshore reverted to it, subject only to the terms and conditions of its plan. 11 U.S.C. §1141. Debtors acting under a plan retain and exercise significant control over their property. There is no longer an

estate or other specific funds or property held in trust under the court's umbrella.[3] There is no basis for a debtor's common law right to designate application of payments to disappear in the Chapter 11 context. If, under some theory, the right to designate the application of payments is divested of a debtor upon the filing of its bankruptcy petition, the right would revert to it upon confirmation of a plan, entitling the debtor to designate how payments would be applied whether or not stated in its plan, so long as such designation was not inconsistent with that plan.

If, on some basis, a debtor's common law right to designate application of payments is divested upon filing a petition in bankruptcy and not revested upon confirmation, historical authorities suggest that where ultimate control over property is subject to jurisdiction of a court, any allocations of payments therefrom are likewise to be made *exclusively* by the court. *See, e.g., First Nat. City Bank v. Kline*, 439 F.Supp. 726, 729 (1977), where payments made pursuant to bankruptcy were later allocated by the Court *pro rata*.

E. Policy considerations do not militate against the application of the common law rules in the Chapter 11 context.

One of the apparently significant influences on the Courts of Appeals for both the Ninth Circuit and the Third Circuit in *Technical Knockout Graphics* and *Ribs-R-Us*, respectively, was the I.R.S. argument, also presented here, that the policies underlying Section 6672 of

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[3] In that way, a Chapter 11 reorganized debtor is in a significantly different position than, *e.g.*, a debtor undergoing a liquidation bankruptcy.

the Internal Revenue Code of 1986 (26 U.S.C.)[4] would be undermined by the allocations proposed by the debtors there, or that such allocations "could defeat the priority scheme established by Congress." *Technical Knockout Graphics*, 833 F.2d at 803. *See, also, In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204. There are at least three analytical problems with that approach.

First, the issue of whether and to what extent a debtor might abuse an otherwise available right so as to conflict with statutory policies addresses the substance of the proposed allocations and is irrelevant to whether the debtor is granted such a right to begin with. In the Chapter 11 bankruptcy context, any concerns over the *substance* of proposed allocations can be evaluated by the exercise of the Court's jurisdiction and discretion. Thus, such policy considerations do not call for the wholesale abrogation of debtors' historical common law rights.

Second, as the Court below noted, I.R.C. §6672 does not express or imply a policy that "responsible officers" should make the Government whole for all tax liabilities and therefore does not support the I.R.S. position. *See, In re Energy Resources Co., Inc.*, 871 F.2d at 232-233. I.R.C. §6672 concerns itself only with "trust fund" taxes, *i.e.*, taxes withheld from wages. That section expresses an intent and policy that *those* taxes are important enough to be collected to the greatest extent possible. Since it is those very taxes which the debtors here seek to pay (not avoid), such an allocation is entirely consistent with the statutory scheme. It is the I.R.S., not the debtors, which seeks to abuse I.R.C. §6672 by using it to

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[4] The Internal Revenue Code of 1986, formerly known as the Internal Revenue Code of 1954, was redesignated pursuant to Section 2 of the Tax Reform Act of 1986 (P.L. 99-514) and is hereinafter referred to as "I.R.C."

support its own (not Congress's) policy of ensuring trust fund taxes are paid *last*. *See, In re Energy Resources Co., Inc.*, 871 F.2d at 232.[5]

Finally, the I.R.S.'s argument is permeated with the implication that "responsible officers" of corporations owing trust fund taxes are "bad guys" who misappropriated government funds held in trust. The suggestion is naive and has little foundation in reality. As a practical matter, a corporation on the verge of bankruptcy is unlikely to have sufficient funds from which to create any trust *res* in the first place, let alone misappropriate it. Lacking funds sufficient for a gross payroll, a corporate officer wishing to keep the business alive will use all available cash to pay *net* payroll. The "withheld" taxes, constituting the difference between gross payroll and net payroll, are not misappropriated- they don't exist. As new funds come into the business, they are used to pay newly maturing obligations which threaten immediate cessation of business. No trust is imposed on those newly acquired funds. *See, Slodov v. United States*, 436 U.S. 238 (1978). When the company's payroll tax deposit becomes due, the business is without funds sufficient to pay the amounts fictionally "withheld" as well as the employer's share of social security (FICA)

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[5] It should also be noted that, as a matter of practice, the I.R.S. does not allocate payments when it receives them. It merely posts the payment to the taxpayer's account for a particular period. It will even, on occasion, reapply the payment to a different period if deemed in its best interest. Any allocation takes place only when the issue arises. Thus, the I.R.S. has claimed and now seeks unfettered discretion to take any position it wants with respect to allocation, at any time, as best suits its then perceived needs, and to change that position at will as the perceived need changes. Uncircumscribed and unreviewed, such is an awesome and unwarranted power, and one neither expressly nor implicitly granted.

taxes also due. The optimistic corporate officer anticipates a "better time" when the entire obligation can be satisfied. If that time never comes, the obligation grows.

Although one may not condone their actions, such businessmen and women have hardly misappropriated Government funds; and they are unlikely to be any more deterred from their actions by the potential denial of the corporation's common law right to allocate payments in a Chapter 11 bankruptcy than they are currently deterred by personal liability under I.R.C. §6672 for amounts fictionally withheld.

CONCLUSION

In determining who has the right and authority to determine how payments made to the I.R.S. will be applied as among various tax liabilities, the long-standing common law rules apply, not a recently created label-dependent dichotomy. The common law recognizes the right of a person to control his own property and therefore how it is to be applied when paid to another. Nothing in the Bankruptcy Code divested the debtors here of that property right. Since the debtors retained that right, its exercise in a Plan of Reorganization (in the case of Newport Offshore, Ltd.) or subsequently (in the case of Energy Resources Co., Inc., by the ERCO Liquidation Trust) was proper, and consequently the orders of the courts below allowing such exercises of the right were proper. If the debtors were divested of their right to designate, the right devolved upon the Bankruptcy Courts, not the I.R.S. as creditor, in which case the Bankruptcy Courts' orders requiring the I.R.S. to allocate the payments as directed were proper.

It follows that the First Circuit below should be affirmed and the designation of Newport Offshore in its plan of reorganization, and that of the ERCO Liquidation Trust in its post confirmation payments, to apply payments to the I.R.S. first to trust fund taxes, be allowed to stand.

Respectfully submitted,

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JANUARY, 1990

No. 89-[illegible]

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

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Question Presented

Whether the Internal Revenue Service may be required to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability.

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 89-255

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

JOINT BRIEF FOR THE RESPONDENTS

Summary of Argument

The consolidated cases before this Court raise the question of whether a Chapter 11 corporate debtor, following the successful confirmation of its plan of reorganization, may designate the allocation of its post-confirmation payments of tax indebtedness to the Internal Revenue Service first to the trust fund portion of the corporation's tax liability, thereby reducing

both its own liability in respect to certain designated taxes as well as the liability of the corporation's "responsible persons" in respect to the same taxes.

In its belief that it is following the common law, the Petitioner (hereinafter "Government" or "IRS") has evolved a policy of allowing taxpayers to designate how "voluntary" payments should be allocated among their tax liabilities. It has, however, reserved to itself the privilege of such allocation when it deems such payments to be "involuntary." In the Chapter 11 context this voluntary-involuntary dichotomy has been frequently litigated. The IRS believes that Section 6672 of the Internal Revenue Code, which imposes upon a corporation's "responsible persons" liability for the corporation's unpaid trust fund taxes, should have a significant penal and deterrent effect. Accordingly, it has taken the position that all tax payments pursuant to a Chapter 11 plan are involuntary, that no power lies in the bankruptcy court to require allocation of the tax payments and that to impose an allocation upon it would impair an overriding federal tax policy of maximizing the total collection of tax revenues.

Both the Government's perception of the common law, as well as its application of the more recently evolved "voluntary-involuntary dichotomy," are in error and, as a result, it is both historically sound and logically appropriate that corporate taxpayers be able to designate the allocation of tax payments made pursuant to confirmed Chapter 11 plans. At common law debtors are free to designate the debts to which their payments should apply when the payments reflect the exercise of control by the payors over the funds paid. Conversely, creditors are free to designate the allocation only if the funds come into their possession without a prior designation or as a result of enforcement action that involves no prior judicial control (i.e. the court as "payor") over the funds. Where a

Chapter 11 debtor makes payments of its own funds, free from actual judicial control, subject to the revesting provisions of 11 U.S.C. § 1141(b) and following confirmation of its plan of reorganization, it has exercised a degree of control that is materially no different from the unfettered control, which the Government considers voluntary, exercised prior to the commencement of the Chapter 11 case; the Government's treatment of the funds received under such circumstances should be equally consistent.

Even if the appropriate common law test were the voluntary-involuntary dichotomy addressed in recent decisions discussed hereafter, the corporate taxpayer should be free to designate the allocation of all payments as it sees fit. First, the payments made incident to a confirmed Chapter 11 plan deserve to be deemed voluntary as a matter of law. Under circumstances where the IRS's total involvement in a Chapter 11 case need not and usually does not extend beyond filing a proof of claim, an act which is not even necessary if the debtor has scheduled the tax indebtedness correctly, where the corporate debtor is doing no more than paying the same tax dollars it previously was obligated to pay but, if it so elects, over a period of time with interest arising from the added flexibility Chapter 11 affords it, and where the bankruptcy court is essentially performing the role of a monitor in what is largely a consensual process involving negotiations among the debtor and various creditor classes, the conclusion should inevitably follow that the payments are made with that degree of freedom that far more closely resembles the debtor's pre-filing behavior than the IRS seizure and levy activity that has been equated with involuntariness. Second, the IRS's dimly relevant revenue rulings and policy statement are entitled to no judicial deference in the application of the common law to the facts here and certainly do not carry the force of law. If the IRS believes that the per se rule set forth by Respondents materially impairs its

tax collection efforts, its remedy quite simply lies in the Congress where, as the First Circuit noted, at least one bill has been introduced to address this allocation issue in a way most satisfactory to the Government.

Assuming, alternatively, that the debtor's post-confirmation tax payments do not warrant being deemed voluntary under the common law (be it defined by IRS policies or otherwise), it nevertheless follows that the bankruptcy court, if it so elects, may designate the allocation of the payments. First, the Government's voluntary-involuntary dichotomy is fundamentally an incomplete recitation of the common law. The importance of a "voluntariness test" does not apply alone to the debtor's payment of the funds, as the IRS argues, but rather as well to the creditor's receipt of the funds, and once a judicial body has intervened and the funds have come within its control, both the debtor and creditor are subject to all of the court's decisions in respect to the funds to which it ministers justice. Because the Government's opposition to voluntariness here is rooted in its perception of extensive judicial involvement, then it follows that the IRS must be bound by the allocation determinations of the court which is in effect controlling the funds turned over to the creditors. Second, bankruptcy courts are courts of equity with broad common law and statutory powers, including those embraced by 11 U.S.C. § 105, and the exercise of that power in designating the allocation of tax payments is a natural, indeed essential, adjunct to not only a host of statutory sections relating to the treatment and determination of tax claims but also the very ability of the court to resolve conflicting interests in order to enable the debtor to preserve its going concern value and to structure a plan of reorganization confirmable under 11 U.S.C. § 1129. Indeed, this exercise of judicial power is recognized by the IRS in the policies set forth in the Internal Revenue Manual.

The discretionary test set forth in the First Circuit opinion appropriately balances competing policies of the bankruptcy and tax laws and, in particular, does no damage to the goals of Section 6672 of the Internal Revenue Code. While the IRS single-mindedly may desire to collect all taxes without regard to the impact on other creditors, the Bankruptcy Code and the goals of Chapter 11, to the contrary, reflect a community of interests and a wide array of adjustments to normal debtor-creditor relationships, including those of the tax authorities. These adjustments include, among others, the ability of a debtor in its plan to pay its priority taxes over a period of six years from date of assessment, 11 U.S.C. § 1129(a)(9), and the division statutorily created between tax claims afforded priority treatment and older, but otherwise enforceable tax claims afforded only general unsecured status, 11 U.S.C. § 507(a)(7). The Government's assertion of a *per se* rule in its favor is not only irreconcilable with clear statutory enactments within the Bankruptcy Code that limit the rights of tax authorities available in the absence of a bankruptcy, but also is irreconcilable with the specific Congressional mandate of Section 6672 that trust fund taxes be accorded a special status and collected as soon as possible to avoid the "double loss" identified by the IRS. The Government's dogmatic adherence to maximizing total tax revenues likewise impairs numerous motivations which would foster reorganization under Chapter 11, in contrast to a Chapter 7 liquidation under which, to the detriment of corporate general creditors, the "responsible persons" might receive the immediate benefit of more rapid payment of priority tax indebtedness. Finally, at a time when the "responsible persons" do not enjoy any shield from the IRS pursuing collection of the trust fund taxes from them, should it wish to do so, confirmation of any Chapter 11 plan must meet the standard set forth in 11 U.S.C. § 1129(a)(11), in respect to which the IRS may appear in objection, that every plan be feasible (i.e. that the tax payments over time likely will be made).

Argument

I. The Government Is Obligated to Honor a Corporate Debtor's Request that Its Priority Tax Payments Under a Confirmed Chapter 11 Plan Be Applied First to Trust Fund Tax Liability.

At issue herein is a taxpayer's right to designate how the tax payments it is making will be applied. This issue is sometimes framed as the question of whether the payments are "voluntary" or "involuntary." The parties agree that a taxpayer making a "voluntary" payment may designate the allocation of such payment among various taxes, penalties and interest. *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); Government Brief at 11, 19. The parties disagree both as to whether the payments involved herein are voluntary and upon the consequences if they are not.

A. *Tax payments made under a confirmed Chapter 11 plan are voluntary payments.*

The issue of whether tax payments under a confirmed Chapter 11 plan should be treated as voluntary can best be resolved by this Court by reference to common sense, in light of the considerable flexibility granted to debtors under Chapter 11 to determine the timing of tax payments. "Voluntariness" is not an amorphous concept. *In re The Franklin Press*, 52 Bankr. 151 (Bankr. S.D. Fla. 1985).

At the outset, it is important to realize that a tax payment is not "involuntary" for these purposes simply because the taxpayer is required by law to make it. That is always true. Outside of bankruptcy, as the IRS will agree (see Government Brief at 20), a taxpayer is considered to have made a voluntary payment even if the payment is made after the date the taxes are

due, after the taxpayer has received a notice of deficiency, after an assessment has been made by the IRS, and even after the taxpayer has received a notice and demand for payment from the IRS, so long as the payment is made prior to an actual levy on the taxpayer's assets.

The Government contends that tax payments made under a confirmed Chapter 11 plan of reorganization are involuntary because the Bankruptcy Code requires the full payment of the taxes within six years of their assessment as a condition of the reorganization. Government Brief at 21-22. Although the Government acknowledges that the debtor has "some degree of 'latitude' as to 'how and when the IRS will be paid'," it contends that such flexibility should not cause the payments to be considered "voluntary" because the debtor's options are limited to paying in less than the six years allowed by the Bankruptcy Code. *Id.*

In the Government's view, the critical fact is that "[o]nce there is a confirmed Chapter 11 plan of reorganization, the debtor does not have the option to decline to pay priority taxes." Government Brief at 21. But, if this were the touchstone of "involuntariness," then all tax payments would be involuntary since no taxpayer, in bankruptcy or out, has the right to simply decline to pay its taxes. In short, Congress' elevation of certain tax payments to a priority status in bankruptcy cases may reflect sound fiscal policy, but it adds nothing new to the characterization of such payments by a confirmed Chapter 11 debtor as voluntary or not.

The Government attempts to overcome this weakness in its reasoning by pointing to an element of coercion behind the tax payments. It points out that a Chapter 11 proceeding must be dismissed or converted into a Chapter 7 liquidation if a feasible reorganization plan cannot be developed, and it reasons from this that the debtor's tax payments "cannot reasonably be regarded as 'involuntary' " because "the corporate debtor's

payment . . . essentially is made under threat of liquidation." Government Brief at 22. In this, too, the Government's shot misses the mark, since in numerous other contexts the mere threat of enforced collection, even if imminent, does not cause a tax payment to be considered involuntary, even by the IRS itself. Thus, for example, a taxpayer that pays its taxes when the IRS threatens a levy or seizure is entitled to designate how the IRS must apply the payment.

A fundamental error in the Government's argument is that it ignores the fact that the Bankruptcy Code actually expands the debtor's options for paying its taxes and restricts the Government's right to collect the taxes involuntarily through seizures. The debtor's right to pay taxes as it chooses over a six-year period actually gives the debtor more options than it has in those situations outside of bankruptcy that the Government would concede are voluntary.

The pertinent distinction is not, as the Government contends, that Chapter 11 requires the relevant tax liabilities to be paid in full. That fact does not distinguish Chapter 11 tax payments from any other tax payments, even payments the Government concedes are voluntary. Instead, the key characteristic of an involuntary payment is the creditor's act of seizing or receiving the property from the debtor's possession, without the interjection of any volitional act by the debtor. This is what makes the payment involuntary. *See Muntwyler* v. *United States*, 703 F.2d at 1033 ("the distinction between a voluntary and involuntary payment . . . is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy."). The fact that a tax liability (or other debt) may be due and owing, delinquent, subject to interest and penalties, and subject to a demand for payment by the creditor or Government, as the Government will concede, will not make the debtor's payment of it involuntary.

Even the Government's emphasis on the "requirement" that it "file claims" (Government Brief at 23) is inaccurate and fundamentally irrelevant to the issue at law. First, there is no requirement that a creditor file a claim in a Chapter 11 case although it may wish to do so in its best interests. Second, a debtor is obligated to file a schedule of its liabilities (11 U.S.C. § 521(1)) and this must be done under oath (Bankruptcy Rule 1007 (b)(1)). Third, unless the indebtedness to the IRS is omitted or is scheduled as disputed, contingent or unliquidated, the IRS need not file anything and its proof of claim shall be deemed filed in the amount scheduled for all purposes relevant to the Chapter 11 case (11 U.S.C. § 1111(a); Bankruptcy Rule 3003(c)(2)), including entitlement to payment.

Thus, the issue here is whether a tax payment made pursuant to a confirmed plan of reorganization in a successful Chapter 11 proceeding is akin to a seizure of the taxpayer's assets by the IRS, or is more like a payment made by the taxpayer itself to the IRS.

A number of the courts that have addressed this issue have examined whether Chapter 11 plan payments are "involuntary." This analysis almost invariably begins with citation of the Tax Court's definition of "involuntary" in *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966): "An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." The analysis then proceeds to consideration of the following statement in the *Muntwyler* decision:

> "[t]he distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action

> or administrative action resulting in an actual *seizure* of property or money as in a levy."

703 F.2d at 1033. The *Muntwyler* court also took as guidance the common meaning of the term "involuntary": "We will not interpret 'involuntary' to mean something completely at odds with the normal understanding of the term. . . ." 703 F.2d at 1034. In another case a bankruptcy court analyzed the *Muntwyler* opinion decision as follows:

> "[A]t each point where the *Muntwyler* opinion discusses court action, including dicta about bankruptcy, it appears that what was contemplated was the kind of court action, such as a seizure or a liquidation, which leaves the taxpayer with no options with respect to the treatment of a claim by the IRS."

In re Gilley Consulting Engineers, Inc., 74 Bankr. 568, 570 (Bankr. N.D. Ga. 1987).

The conclusion that payments made by a Chapter 11 debtor are "voluntary" follows from a recognition of the framework established by the Bankruptcy Code within which the debtor operates. Chapter 11 contemplates an orderly process in which the debtor will reorganize its financial affairs and satisfy its creditors in an equitable and feasible manner. Except in cases of fraud or serious mismanagement, the debtor's current management is left in control of its business. 11 U.S.C. § 1104(a). The filing of the Chapter 11 petition invokes an automatic stay of creditors' collection activities, giving the debtor the breathing space it needs coherently to arrange its affairs. *See* S. Rep. No. 95-989, 95th Cong., 2d Sess. 49-51 (1978). The focus is on the debtor and what it can do for itself, if permitted the opportunity. Chapter 11 provides the respite from creditor pressures the debtor needs to organize its own affairs and,

indeed, to assure that the payment scheme that it works out is truly voluntary.

In the formulation of a plan, the emphasis is on agreement and acceptance, 11 U.S.C. § 362(a); *see* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 224 (1977). The debtor is given an exclusive period within which only it may file a reorganization plan. 11 U.S.C. § 1121(b). Once a plan is filed, it is the creditors in the first instance who decide whether to accept or reject the plan. In a departure from practice under the former Bankruptcy Act, the court's role in the initial step toward a plan is simply to assure that creditors have sufficient information to make an informed decision; the court does not rule on the content of the plan before sending it to creditors. 11 U.S.C. § 1125; H.R. Rep. No. 95-595, *supra*, at 226. While the Bankruptcy Code does set certain broad parameters for the treatment of claims, a topic discussed in more detail below, it provides in each instance that a creditor may accept a different treatment of its claim. 11 U.S.C. § 1123(a)(4); 11 U.S.C. § 1129(a)(7); 11 U.S.C. § 1129(a)(9). Only after the creditors have expressed their sentiments with respect to the plan does the court address its merits and, when it does so, the court's role is confined. Section 1129 *requires* the court to confirm the plan if the standards set forth therein are met. 11 U.S.C. § 1129(a)-(b).

The Government notes the specific provision in § 1129(a)(9)(C) that tax claims be paid within six years of the date of assessment. Government Brief at 21-22. This is one of several provisions in which Congress legislated favored treatment of certain claims, including those of post-petition suppliers, the debtor's employees, consumers who placed deposits, and U.S. fishermen. *See* § 1129(a)(9)(A)-(C); § 507(a). In contrast to the other such provisions, which require immediate payment in cash in full unless the creditors agree otherwise, § 1129(a)(9)(C) permits the debtor to structure its payments to the taxing authority *as it sees fit*, so long as the Government ultimately

receives the present value of its claim in no less than six years after assessment.

Far from being an onerous provision, the six-year stretch-out affords the Chapter 11 debtor greater latitude than that available to a non-debtor, from whom the IRS may and probably will demand immediate payment of delinquent taxes. The flexibility afforded by § 1129 gives the debtor even more freedom as to the timing, manner and amount of tax payments than it would have in making voluntary payments outside of bankruptcy. The Government has fewer options to enforce such payments and has been precluded from exercising the power it would otherwise have to collect the taxes from the debtor involuntarily. Thus, there is no logical reason to conclude that payments under a Chapter 11 plan are not "voluntary."

This "common sense" analysis of the voluntary nature of payments under a Chapter 11 plan, based on the rehabilitative purpose of the Bankruptcy Code and the ordinary meaning of the term "voluntary," was made correctly by both bankruptcy courts below and ratified in the Energy Resources case by the district court. The First Circuit did not conclude otherwise, though it accepted, evidently reluctantly, the IRS's conclusion that it may treat the payments as involuntary, but only "for purposes of its own rules," despite what the court of appeals recognized as "the strength of the arguments favoring a determination that [the] payments are voluntary."[1]

The wide latitude afforded the Chapter 11 debtor in when and how to structure payments to its creditors has also resolved

[1] As noted later, even this degree of deference by the First Circuit was unnecessary, since the IRS's policy is based upon nothing more than that agency's interpretation of common law principles outside of its area of expertise. In any event, the First Circuit's limited acceptance of the IRS's labeling of the payments as involuntary did not affect the result, since the court held that regardless of the label that the IRS attached to them for its own purposes, the bankruptcy court possessed the power to override the IRS and designate the application of the payments in furtherance of the plan of reorganization.

for other courts the question of whether plan payments are voluntary. In *In re Lifescape, Inc.*, 54 Bankr. 526, 528 (Bankr. D. Colo. 1985), the court adopted the rationale set forth in *In re A & B Heating and Air Conditioning, Inc.*, 53 Bankr. 54 (Bankr. M.D. Fla. 1985), *aff'd*, 86-2 U.S.T.C. (CCH) 9520 (M.D. Fla. 1986), *remanded*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S.Ct. 1724 (1988), *held not moot on remand*, 861 F.2d 1538 (11th Cir. 1989):

> "[A] Chapter 11 debtor enjoys great latitude in how and if a plan is proposed and thus how and when the IRS will be paid. . . . The debtor propounding a plan has a number of options with respect to treatment of a claim by the IRS and it is the freedom afforded by these options which dictates the conclusion that payments to the IRS pursuant to a confirmed Chapter 11 plan of reorganization are voluntary."

Accord, In re Greenberg, 105 Bankr. 691 (Bankr. M.D. Fla. 1989) (following *In re Energy Resources, et al.*).

Where, as in the present cases, funding for the plan has been provided by an outside source, the lack of coercion is particularly evident. *In re The Franklin Press*, 52 Bankr. 151 (Bankr. S.D. Fla. 1985). The outside party is not subject to the control of the bankruptcy court and cannot be required to contribute to the plan. *Id.* Payments made with funds supplied or arranged by a third party can only be held to be voluntary. *Id.*

A payment of federal taxes made pursuant to a Chapter 11 plan is not "involuntary" in the sense contemplated by the *Amos* and *Muntwyler* decisions. *In re Lifescape, Inc.*, 54 Bankr. at 528-29. The wide latitude afforded the Chapter 11 debtor in structuring its plan and the limited role of the court in confirming that plan demonstrate that the action of a Chapter

11 court falls far short of the coercive power of a levy, execution or judicial sale. *Id.*

The Government attempts to shift the focus in this analysis from the rehabilitative purpose of Chapter 11 to the responsibilities imposed on a debtor by the Bankruptcy Code. The Government relies on three recent circuit court decisions, *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987), *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987), and *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988). Respondents maintain that the *Ribs-R-Us* and *DuCharmes* decisions are incorrect and the *Technical Knockout Graphics* case is both incorrect and distinguishable.

In *Ribs-R-Us*, the court of appeals based its decision on the narrow and pessimistic view that a Bankruptcy Code proceeding can only be regarded as a last resort by a debtor desperate for a stay of creditor action and a Chapter 11 discharge. *See* 828 F.2d at 203. The Third Circuit lost sight of the rehabilitative purpose of Chapter 11, which preserves the debtor's options other than liquidation, and it failed to distinguish between the inevitable obligation to pay taxes in bankruptcy, which it stressed, and the same inevitable obligation outside of bankruptcy, which clearly allows for designation by the taxpayer. The responsibilities to creditors placed on the debtor in possession are a reasonable exchange for the forbearance from collection action imposed on creditors; they assure that *all* creditors, not just those with the largest claims, or the greatest leverage, will be considered. In this way, the debtor's assumption of these responsibilities promotes the creditor equality that assures that its conduct under Chapter 11 *will* be voluntary. The attitude reflected in the *Lifescape* and *A & B Heating and Air Conditioning* decisions is far more consistent with the rehabilitative purpose of the Bankruptcy Code than the negative approach taken in *Ribs-R-Us*.

The Government also relies on the decision in *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987). In *Technical Knockout Graphics*, the payments at issue were not made pursuant to a plan of reorganization but were made prior to the proposal of a plan, at the debtor's request. In refusing to permit their allocation by the debtor, the court stressed what it termed "abuse" of the bankruptcy system by a designation that benefited the principals and "possibly harm[ed] other creditors" without notice to the creditors or approval of the court.

The *Technical Knockout Graphics* decision is inapplicable to the present case for two reasons. First, considerations applicable to a partial payment of a pre-petition claim outside a plan, before it is clear that there will be sufficient assets to pay claims of higher priority, and before the debtor's assets revest in it incident to confirmation of the plan (11 U.S.C. § 1141(c)), are clearly different from those concerning a confirmed plan of reorganization which provides for satisfaction of senior claims and payment of tax claims in full. Second, in *Technical Knockout Graphics* the court failed to distinguish between a taxpayer's right to allocate its tax payments and abuse of that right by a debtor. The disclosure, notice and hearing provisions surrounding a reorganization plan assure that creditors will understand the plan's provisions and may object to any harm to their interests. The potential for abuse that concerned the *Technical Knockout Graphics* court is amply addressed in the Bankruptcy Code; it is not necessary to deny *all* debtors the benefits of designation in order to guard against such abuse.

B. *The IRS's policy characterizing Chapter 11 plan payments as involuntary is not entitled to judicial deference.*

The Government's conclusion that the tax payments involved herein are not voluntary, which is the linchpin of its

position, is not entitled to judicial deference. No statute or regulation mandates the IRS's application of tax payments under a confirmed Chapter 11 reorganization plan and indeed a recent legislative effort intended to afford the IRS the power it asserts herein failed. Government Petition at 20a. The only administrative authority that the Government could point to is the bald statement that such payments are involuntary set out in § 57(13)4.3 of the Internal Revenue Manual and certain revenue rulings,[2] neither of which have the force or effect of law. As one court has aptly observed:

> "A ruling is merely the opinion of a lawyer in the agency and must be accepted as such." (citations omitted).

Stubbs, Overbeck & Associates, Inc. v. *United States*, 445 F.2d 1142, 1146-7 (5th Cir. 1971). Rulings do not even have the effect of a regulation. *Id.* The Internal Revenue Manual, likewise, because its purpose is to govern the internal procedural affairs of the IRS, does not carry the force or effect of law. *Vallone* v. *Commissioner*, 88 T.C. 794, 807 (1987).

[2]Contrary to the Government's position, IRM § 57(13)4.3, surprisingly not cited in the Government's brief, actually states that all payments received from bankruptcy proceedings shall be applied pursuant to orders of the court if such direction is given. The Government does cite four revenue rulings (Government Brief at 20), but none of these rulings involves a bankruptcy reorganization or any other judicial proceeding. Rev. Rul. 73-304, 1973-2 C.B. 42; Rev Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43; superceding Rev. Rul. 58-239, 1958-1 C.B. 94. And, none of these rulings pertains in any way to involuntary payments. Instead, the cited rulings merely state that the IRS will honor a taxpayer's designation of payments that it makes voluntarily, but that if no such designation — of voluntary payments — is made, the IRS will apply those payments either in a specified order (Rev. Rul. 73-304, Rev. Rul. 73-305, Rev. Rul. 58-239) or in some other manner serving the IRS's best interest (Rev. Rul. 79-284). The rulings do not address at all the issue of whether payments under a confirmed Chapter 11 reorganization plan are voluntary or involuntary or how such payments would be treated if they were held to be involuntary.

Indeed, even with respect to the IRS itself, "the policies and guidelines set forth in the Internal Revenue Manual are directory, not mandatory." *Timmerman et al.* v. *Swenson et al.*, 79-2 U.S. Tax Cas. (CCH) ¶9588 (D. Minn. 1979) (collecting cases). Moreover, those IRS rulings are, in large measure, irrelevant because they do not address the issue of the allocation of payments in a Chapter 11 case, where, for the reasons argued above, the nature of the taxpayer's actions is considerably different from that in the liquidation, seizure or levy context. All of the IRS's issuances are, not surprisingly, concerned only with one creditor — the IRS. As is stated in Rev. Rul. 79-284, *supra*, n.1, "[T]he Internal Revenue Service will allocate partial payments of withheld employment taxes . . . *in a manner serving [the IRS'] best interests*." (emphasis added). Of course, no internal rule of an agency can circumscribe a court's power to act or to interpret the proper application of the law. *See Dixon* v. *United States*, 381 U.S. 68, 74 (1965).

Because the First Circuit appeared to afford the IRS's position a presumption of validity (Government Petition at 12a), it fundamentally failed to decide an essential issue before it, i.e. whether or not the debtor's characterization of its payments as voluntary was within the common law rule allowing such payments to be allocated to specific debts. Government Petition at 7a-8a. Stating, as the court of appeals did, that one cannot say the IRS's view is clearly unreasonable, is simply not deciding what was a pure question of law before it under circumstances where the IRS's view was entitled to no presumption of validity in applying the facts to the common law.

The Government acknowledges that the IRS's policy is based only upon its interpretation of common law principles pertaining to debtor/creditor relations. Government Brief at 19-20. But, the IRS has no special expertise in the interpretation of such general common law principles that would entitle its inter-

pretation to judicial deference. *UPG, Inc.* v. *Edwards*, 647 F.2d 147, 156 n.23 (Temp. Emer. Ct. App. 1981) ("If the interpretation is not based on expertise in a particular field . . . but is, instead, based on general common law principles, great deference is not required."). As discussed above, the IRS's conclusion that tax payments under a confirmed Chapter 11 plan are involuntary, and its additional conclusion that the common law allows it, as creditor, to apply involuntary payments as it sees fit, rather than to follow the bankruptcy court's designation, are both wrong.

C. *Tax payments made under a confirmed Chapter 11 plan reflect the exercise of control by the debtor over its own property within the meaning of the common law.*

As addressed at length in the Amicus Brief of GLK, Inc., the voluntary-involuntary dichotomy wrestled with by the circuit courts of appeals may reflect an unintentional deviation from traditional common law principles. To the extent that is true, the essential feature justifying the right to designate the application of debt payments lies in the right of control over and ownership of the funds at the time of payment. *Orleans County Nat'l Bank* v. *Moore*, 112 N.Y. 543, 20 N.E. 357 (1889); *Bank of California* v. *Webb*. 94 N.Y. 467, 472 (1884). In that spirit, it is clear that at the time of payment in both of the Chapter 11 cases at issue here, the designated payments were made following confirmation of the reorganization plan under 11 U.S.C. § 1129, at a time when any and all property formerly of the estate was revested in the debtor (or in the case of Energy Resources its designee), 11 U.S.C. § 1141(b), free and clear of all claims and interests of creditors except as otherwise provided in the plan or the order of confirmation (11 U.S.C. § 1141(c)). In this respect, *Technical Knockout Graphics*, *supra*, again is distinguishable because at the time of

payment, in that case prior to confirmation of a plan, the payment was out of funds of the estate and not in the ordinary course of business. If, as the IRS will concede, a voluntary pre-bankruptcy payment by a troubled corporation owning and controlling the funds paid may be designated by the payor, binding the IRS, then it should logically follow that a similar payment, post-confirmation, by a now rehabilitated and financially reorganized corporation, owning and controlling the "same" funds paid against the "same" array of tax indebtedness, should be able to be designated by the payor, equally binding the IRS.

II. The Bankruptcy Court Has the Power to Designate the Application of Tax Payments Under a Confirmed Chapter 11 Plan Regardless of Whether the Payments Are Considered to Be Involuntary.

Respondents contend that it is both necessary and appropriate for this Court to determine that the designation of tax payments under confirmed Chapter 11 plans should be binding upon the IRS, whether because the payments are voluntary, within the meaning of the voluntary-involuntary dichotomy wrestled with by the recent courts of appeals decisions, or because the payments reflect traditional ownership and control indicia within the scope of the historic common law analysis. However, if this Court concludes that the payments are involuntary, or that the ownership and control of the funds is not sufficiently limited solely to the corporate t payer after confirmation of the plan, then Respondents submit for the reasons stated below that the bankruptcy court, and not the IRS, possesses the legal power to allocate the post-confirmation tax payments to the "trust fund" tax liabilities first. In this regard, the First Circuit, ac-

knowledging that there is a community of creditor interests[1] competing for limited resources in a Chapter 11 case, whose interests are better served by the debtor's rehabilitation, rather than liquidation, announced a rule that strikes an appropriate balance between the equally important Congressional goals of reorganizing a troubled enterprise and providing for the payment of federal taxes.

A. *When funds are disposed of by a court, particularly under circumstances affecting many creditors, the court has the power to order allocation of the tax payments.*

At common law, as argued at length in the Amicus Brief of GLK, Inc., it is the court which should dictate the application of funds where such funds come within the ambit of a judicial proceeding for the reason that control over and ownership of the funds more logically reside in the court, as opposed to either the party obligated on the debts affected by disposition of the funds (Energy Resources and Newport) or the party anticipating receipt of the funds (IRS). *Bank of California* v. *Webb*, *supra*; *Orleans* v. *Moore*, *supra*. As the court stated in *Webb*, "[i]f neither party makes any application of the

[1] In commenting on how Congress in general has required that in bankruptcy cases creditors sublimate their individual interests to the interests of the community of creditors, Professor Thomas H. Jackson wrote:

> "The single most fruitful way to think about bankruptcy is to see it as ameliorating a common pool problem created by a system of individual creditor remedies. Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together.
>
> This approach immediately suggests several features of bankruptcy law. First such a law must usurp individual creditor remedies in order to make the claimants act in an altruistic and cooperative way. Thus, the proceeding is inherently by collective."

T. Jackson, *The Logic and Limits of Bankruptcy Law*, Harvard University Press (1986) at 16-17.

payment (when it has control over it) and the matter comes into court, then the court will make such application of the payment as equity and justice require." 94 N.Y. at 472.

Under this common law concept, therefore, even though a debtor cannot designate the application of an involuntary payment, it does not follow automatically that the creditor can unilaterally make that decision. The Government's reliance upon 60 Am. Jur. 2d *Payment* § 103 (1987) and 70 C.J.S. *Payment* § 37 (1987) is misleading and misplaced because, as the latter treatice makes clear, "(t)he application of an involuntary payment rests in the discretion of the court. . . ."

The Government's conclusion that the payments at issue here were involuntary requires it to emphasize the sentence in *Amos* v. *Commissioner*, *supra*, referring to "a legal proceeding" (47 T.C. at 69) and the alleged "considerable extent of judicial involvement in a Chapter 11 proceeding. . . ." (Government Brief at 22). However, the IRS may not have it both ways. Either it receives the funds "involuntarily" without the intervention of a judicial proceeding, and thus may make the allocation, or it benefits from the judicial involvement and control over the funds, and thus may only accept the funds with whatever allocation the court has seen fit to impose as a matter of equity.

Amos v. *Commissioner*, *supra*, is not only consistent with the foregoing general rule but it and several recent decisions even bolster the conclusion that when there is judicial involvement in the disposition of the funds sought to be allocated, particularly where other creditors are involved, the court has the power to allocate if it seeks to act. In *Amos* the Tax Court specifically pointed out — the first of two important caveats to its holding — that the recipient's ability to allocate involuntary payments may *not* be available at all when the interests of other creditors are affected by the allocation sought to be made by the IRS, stating:

> "We expressly refrain from deciding whether the same right of application governs where the rights of other creditors may be adversely affected. Cf. *Commercial Credit Corporation* v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955)."

Amos at 70, n.5. Thus, in those Chapter 11 cases where, in accordance with the test applied by the First Circuit, the interests of other creditors are affected by the allocation issue, the general rule in *Amos* is inapplicable. What the *Amos* court recognized is that the inquiry should not end and a ruling mechanically follow even when a payment may be found to be "involuntary." Instead, that court observed that where the interests of other creditors are implicated by the allocation issue, a court must consider the interests of those affected creditors.

This caveat to the holding of *Amos* is one that has long been followed by courts. Even where the payment is "involuntary," where the interests of other creditors are affected by the manner in which payments to one creditor are allocated and a court has control over the money to be paid (or from which the payment is to be made), then it is within the power of a court to direct an allocation of payment. In doing so, a court must follow basic principles of equity, seeking to protect the rights of all parties. *United States* v. *Transamerica Insurance Company*, 357 F. Supp. 743, 748 (E.D. Va. 1973) (collecting cases).

In *Transamerica*, the United States sought to apply a payment of approximately $31,000, designated by the debtor to be applied to back rent for the year 1963, instead to back rent for 1967 and 1968. The defendant in the case had issued a surety bond to cover unpaid rent only for 1963 and the United States, of course, hoped by applying the funds to the later years to hold the solvent surety liable on the 1963 back rent, thereby maximizing its total collection of funds owed by the

debtor. Although the court found that the payment was "involuntary," it refused to allow the Government to allocate the payment, stating, "This finding [of involuntariness] does not result, however, in a conclusion that the United States was free to apply the sum as it chose. To the contrary . . . the duty falls upon (the court) to do so." 357 F. Supp. at 748. The court was unable to decide on the record before it how the payment should be allocated because there was insufficient evidence to determine how other creditors would be affected by the allocation and left that issue to trial.

Similarly, in *First National City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D. N.Y. 1977), the court held that:

> "Where, as here, moneys are repaid under judicial order, the court has exclusive authority to apply the funds and its application must be structured as 'equity and justice require'." (citations omitted).

Likewise, in *Commercial Credit Corp.* v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D. Ark. 1955), cited by the Tax Court in *Amos* in announcing one of the caveats to its general rule, the court, in the exercise of its equitable powers, set aside an allocation of payment (which was clearly "involuntary") the IRS wished to make because that allocation would have been inequitable to other creditors seeking to obtain some satisfaction of their claims from the same property that was subject to the IRS claims. Although the IRS insisted that its allocation was legal and proper, 130 F. Supp. at 529, the court set it aside because it was inequitable to other creditors. *Id.* at 530.

The three cases cited above, *Transamerica Insurance Company*, *First National City Bank* and *Commercial Credit Corp.*, all uphold the proposition that when a court controls or supervises the money or other property from which a payment is to be made, then, even if the payment is "involuntary," it is for

the court, not the creditor, to decide how the payment will be applied, and the court will apply the payment equitably. In fact in *Amos* itself, the Tax Court, implicitly recognizing this rule, indicated — its second caveat — that a creditor's right to apply an "involuntary" payment has no application in a bankruptcy case where property is under a court's supervision. It stated:

> "Usually cases applying this rule [that even "involuntary" payments may not be applied in the manner in which the creditor unilaterally decides] involve judicial proceedings, such as *bankruptcy*, receivership, probate, or mortgage and lien foreclosures, in which sale of the property is under the umbrella of the court's supervision. *In such situations, the court, in its discretion, determines the application of payments according to legal and equitable principles.*" (emphasis added).

47 T.C. at 68 n. 3.

Clearly, the rule that emerges from *Amos* does not aid the Government in the context of a Chapter 11 case where the interests of other creditors may be affected by the allocation issue, and where a bankruptcy court, arguably, has supervisory (and ultimate) control over a debtor's property from which payments to the IRS are to be made. In the final line in the above quotation from *Amos*, the Tax Court distinguished the situation (and rule that emerges) where a court has supervision over the property from which a payment is to be made from that immediately before it where a court had no such supervision or control, stating:

> "There is no supervision or control over payments received by a district director as a result of administrative collection of Federal taxes by levy or distraint."

Id. In *Amos*, the Tax Court concluded, correctly, that the IRS could, in the absence of court control or supervision over the property that was subject to its levies, apply the proceeds from the execution of those levies as it saw fit. Its ruling is limited to the facts before it, which are readily distinguishable from those in a Chapter 11 case.

B. *Bankruptcy courts in particular have the statutory power to order allocation of the tax payments.*

Bankruptcy courts have long been considered courts of equity, *Pepper* v. *Litton*, 308 U.S. 295, 304-05 (1939); *United States Bank* v. *Chase Bank*, 331 U.S. 28, 36 (1947); *Katchen* v. *Landy*, 382 U.S. 323, 327 (1966), and Congress has granted bankruptcy courts broad equitable powers, including those powers "expressly or by necessary implication conferred by Congress." *Johnson* v. *First Nat'l Bank*, 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984). Specific authority for the exercise of equitable powers by bankruptcy courts is found in 11 U.S.C. § 105, which provides that such courts "may" issue any order, process or judgment that is necessary *or appropriate* to carry out the provisions of this title [the Bankruptcy Code]" (emphasis added). The First Circuit correctly found that "at least on some occasions," exercise of a bankruptcy court's equitable power to allocate payments under the limited circumstances[4] it outlined would be "appropriate" (Government's Petition at 13a) since, under the court's

[4] It is noteworthy, and should ameliorate any concern the Government has that the debtor's allocation of tax payments will be "routinely" allowed, that the bankruptcy court which fashioned the approach the First Circuit generally adopted, *In re B & P Enterprises, Inc.*, 67 Bankr. 179, 183 (Bankr. W.D. Tenn. 1986), (Government Petition at 21a), found under the facts and circumstances of that case that the plan proponent would *not* be permitted to designate payments to the IRS.

test, such power is to be invoked only where it will further the central and overriding purpose of Chapter 11 — the rehabilitation of the debtor — with, at the same time, due deference to the importance of paying federal tax claims. *Accord*, *Matter of A&B Heating and Air Conditioning*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S.Ct. 1724 (1988), *held not moot on remand*, 861 F.2d 1538 (11th Cir. 1989); *see Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197 (1988) (equitable powers of bankruptcy courts "must and can only be exercised within the confines of the Bankruptcy Code.")

The Government contends that allowing allocation of tax payments is beyond the scope of a court's power under § 105, that bankruptcy courts are not "roving courts of equity" and that such a ruling would not be in step with the generally recognized proposition that § 105 neither authorizes bankruptcy courts to create substantive rights that do not exist under state law or otherwise enter orders contrary to the express provisions of the Bankruptcy Code ("Code"). Respondents submit that this case crosses none of these boundaries. The cases cited by the Government in support of these propositions are vastly different than the case now before the Court because they address areas where the lower courts used § 105 to craft a result contrary to the intended import of specific statutory provisions. In *United States* v. *Sutton*, 786 F.2d 1305 (5th Cir. 1986), the lower court held that under § 105 a trustee had the authority to pay support to a debtor's wife and children. The district court reversed and the circuit court affirmed the district court, finding that the distributions were not justifiable as compensation for services rendered to the estate, and thus did not qualify as administrative expenses. Moreover, the distributions did not fall within the scope of the Code provisions expressly enacted to address a debtor's support obligations. In *In re NWFX, Inc.*, 864 F.2d 593 (8th Cir. 1989), the court of appeals reversed a lower court's ruling allowing setoff even

in the absence of mutuality of debt, finding that the court's reliance on § 105 to fashion an equitable right to setoff broader than that contained in the Code (11 U.S.C. § 553) was improper because it created new substantive rights inconsistent with those in the Code. In *Official Committee of Equity Holders* v. *Mabey*, 832 F.2d 299 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988), the district court authorized the debtor to set up an emergency treatment fund for individuals adversely affected by the debtor's product. The court of appeals reversed the district court, holding that the fund violated the clear policy and intent of the Code preventing piecemeal payment to unsecured creditors except under a properly presented and approved plan of reorganization.

Allocation of tax payments requires neither the creation of new substantive rights nor the violation of the provisions and policies expressed in the Code. It is therefore well within the scope of the powers available to the court under § 105 and logically is but an adjunct to the exercise of power under several provision of the Code which address the treatment of tax claims. See, for example, 11 U.S.C. § 507(a)(7) providing for the priority payment of tax claims, 11 U.S.C. § 1129(a)(7) providing for the possible payment of tax claims over a six-year period, and 11 U.S.C. § 505 providing for determination of the amount of tax claims. A court order concerning the proper allocation of tax payments is a logical carrying out of these provisions, particularly § 505 because such an order will dictate which components of the IRS's claim are being paid with what dollars.

The Government suggests that the equitable powers conferred on the bankruptcy court under § 105 are narrowly limited to the issuance of orders such as injunctions or contempt findings where such orders are necessary to implement the clear substantive provisions enacted by Congress. In so arguing, the Government ignores the fact that there are many other types of equitable powers that bankruptcy courts have traditionally

exercised although such powers are not found in the strict four corners of the Bankruptcy Code. *See, e.g., In re Morahan*, 53 Bankr. 489 (D.Me. 1985) and *In re Ann Arbor Brewing Co.*, 110 F. Supp. 111, 116 (E.D. Mich. 1951), in which the courts applied the equitable doctrine of marshalling to adjudicate rights of competing lienholders; *Browning* v. *Navarro*, 887 F.2d 553, 559 (5th Cir. 1989), where the court, recognizing that bankruptcy courts are in the business of allowing and disallowing claims, found that voiding a state court judgment on grounds that it was fraudulently obtained is within the ambit of § 105; *In re Ranch House of Orange-Brevard, Inc.*, 773 F.2d 1166, 1169 (11th Cir. 1985), where the court stated that a bankruptcy court has the power to employ the equitable doctrines of waiver and estoppel in adjudicating the rights of parties to an expired lease.

The First Circuit fashioned the following test in this case to determine under what circumstances tax payments may be allocated:

> ". . . upon consideration of the reorganization plan as a whole, insofar as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, i.e., increased likelihood of payment to creditors who might otherwise lose their money?
>
> * * *
>
> In applying this test, of course, the bankruptcy court must recognize the obvious importance of satisfying tax liabilities. . . ." (Government Petition at 21a).

That test is very similar, in its focus, to the test this Court set forth in *N.L.R.B.* v. *Bildisco and Bildisco*, 465 U.S. 513

(1984),[5] in which one important national goal, preserving the rights of workers under collective bargaining agreements, converged with the overarching goal of Chapter 11 — the successful rehabilitation of debtors. There this Court stated:

> "Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection [of collective bargaining agreements] should not be permitted without a finding that that policy would be served by such action.
>
> * * *
>
> Determining what would constitute a successful rehabilitation involves balancing the interests of the affected parties — the debtor, creditors and employees. The Bankruptcy Court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them . . .
>
> * * *
>
> The Bankruptcy Court is a court of equity, and in making this determination it is in a very real sense balancing the equities . . . Nevertheless, the Bankruptcy Court must focus on the ultimate good of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization." At 527.

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[5] Although there was a dissenting opinion in *Bildisco*, there was unanimity concerning the appropriateness of this test, as the dissenting justices agreed that it properly accommodated the policies of the National Labor Relations Act and the Bankruptcy Code. 465 U.S. at 535.

As this Court was in *Bildisco*, the First Circuit was concerned about furthering the overriding policy of Chapter 11. It fashioned an equitable test that was calculated to do so, while at the same time respecting an important competing policy goal involving the collection of tax revenues.

C. *The IRS's position is at odds with its own policy deferring to judicial direction.*

The Government's opposition to the court ordered designations involved herein violates that agency's own internal rules. Those rules are set out in § 57(13)4.3 of the Internal Revenue Manual, which states without analysis or explanation the IRS's view that tax payments arising in a bankruptcy proceeding "are considered involuntary." Sec. 57(13)4.3(1). Significantly, however, the Manual also states that such "*[p]ayments received from [bankruptcy] proceedings should be applied as set out in the court order*, or, if no such direction is given, the money should be credited in such a manner as to give maximum benefit to the United States insofar as future collections are probable." *Id.* (emphasis added); *see also* IRM § 57(13)5.4(4). While the Manual does lay out a hierarchy for the application of payments (with trust fund taxes in the fourth of five categories), the Manual is explicit that that hierarchy applies only "*[t]o the extent it is consistent with any applicable [court] order*." *Id.* In other words, even under the IRS's own rules, it claims to have blanket authority to apply tax payments such as those involved herein as it see fit only "if no [contrary] direction is given" by the bankruptcy court. *Id.* This is precisely the position the IRS appeared to have taken in the Energy Resources case when it rejected the trustee's check and informed him by letter that "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment . . . to its maximum benefit." Government Brief at 4. The Government has offered no explanation as to why the IRS should be free to ignore its own rules and/or policies in this case.

D. *The First Circuit's test represents an appropriate balancing of two equally important national goals that converge in Chapter 11 cases.*

The Government misinterprets the law and overstates its case in arguing that "there is a 'clear policy judgment by Congress' favoring collection of priority taxes over the debtor's rehabilitation." (Government Brief at 32, citing to *United States* v. *Gurwitch*, 794 F.2d 584, 585-586 (11th Cir. 1986)).[6] Neither Congress nor this Court has stated or implied that the important goal of paying federal taxes predominates over the important goal of rehabilitating and reorganizing a business enterprise. Through a series of carefully crafted Bankruptcy Code provisions, Congress has provided for a mutual coexistence of these goals. The rule announced by the First Circuit preserves the balance Congress sought to achieve and harmonizes those competing policies just as this Court has done in other bankruptcy cases where legitimate and important competing policies of national importance converged.[7]

Bankruptcy courts hold an array of powers with which, in general, to effect Congressional and long-honored judicial

[6] The Government has quoted from *Gurwitch* out of context and given a slant to it never intended by the Eleventh Circuit. What the court of appeals held there was that the personal tax obligations of the taxpayer, which he acknowledged owing and which were clearly non-dischargeable to begin with, were neither reduced nor rendered dischargeable upon the close of his case under the doctrine of res judicata or collateral estoppel by the IRS's filing of a proof of claim for an amount less than the amount he conceded was owed to it. There are two Bankruptcy Code provisions that clearly defeat the argument the taxpayer raised, which probably explains why the court's opinion is so brief.

[7] *See N.L.R.B.* v. *Bildisco and Bildisco*, *supra*, and *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198 (1983).

notions of "equity" between a debtor and its creditors and among classes of creditors. The specific adjustments in normal (i.e. non-bankruptcy) debtor-creditor relationships that occur in a bankruptcy case, from which federal tax claims are not immune, reflect Congress' desire to further one or more general policies that pervade bankruptcy law. Among those general policies is Congress' desire to encourage the reorganization of a debtor, rather than to oversee its liquidation, and thereby provide the greatest return for the greatest number of creditors.[8]

These notions of equity and collectivism find expression in many Bankruptcy Code provisions. A creditor who has received a "preferential" transfer, for example, must return the money or other property received to the debtor's bankruptcy estate because Congress has provided in 11 U.S.C. § 547 that it is simply fair and equitable to all other creditors that that be done. This is so even though as between that creditor and the debtor it may have had a legitimate right to retain that money or other property and could have done so but for the subsequent filing of a bankruptcy petition. Congress has also, for example, severely limited the amount of otherwise valid lease or employment termination claims under 11 U.S.C. § 502(b)(6) and (7) respectively in order to increase the likelihood of other general unsecured creditors receiving a dividend in the case.[9] It has provided through 11 U.S.C. §§ 365 and 1113 that a debtor can reject a valid executory contract, unexpired lease or collective bargaining agreement, for example, when doing so will facilitate reorganization and thereby benefit the bankruptcy estate and creditors in general. Other, uncodi-

[8] See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 220 (1977). *United States* v. *Whiting Pools, Inc.*, 462 U.S. at 527; *N.L.R.B.* v. *Bildisco and Bildisco*, 465 U.S. at 203; *Pension Benefit Guaranty Corp.* v. *LTV Corporation*, 875 F.2d 1008, 1016 (2d Cir. 1989).

[9] See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 352-354 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 62-5 (1978).

fied principles and doctrines grounded in notions of equity, such as marshalling of assets, have been regularly applied by bankruptcy courts in order to benefit all creditors. *See, e.g., Caplinger* v. *Patty*, 398 F.2d 471, 474 (8th Cir. 1968); *In re Jack Green's Fashions for Men*, 597 F.2d 130, 133 (8th Cir. 1979).

Although federal tax claims merit important consideration in bankruptcy cases, they are by no means inviolable, as one might infer from reading the Government's brief. There are a host of Bankruptcy Code provisions that apply to reduce and otherwise affect federal tax claims and interests in precisely the same manner as claims of other creditors are adjusted and affected. Indeed, not all tax claims are afforded priority status, 11 U.S.C. § 507(a)(7), and in at least one instance Congress has rather dramatically impaired federal tax claims in bankruptcy cases while leaving equivalent non-federal tax claims entirely unimpaired.[10]

For example, just as is true of all other unsecured claims, interest ceases to run on unsecured federal tax claims during a bankruptcy case. *See* 11 U.S.C. § 502(b)(2); *In re Reich*, 66 Bankr. 554, 557 (Bankr. D. Colo. 1986) and *In re Brent Explorations, Inc.*, 91 Bankr. 104, 110 (Bankr. D. Colo. 1988). Penalties on federal tax claims are specifically subordinated to general unsecured claims, 11 U.S.C. § 726(a)(4), in order to, in fairness, permit general unsecured creditors to receive a greater return on their claims; and otherwise valid liens securing the payment of such penalties are voidable, 11

[10] Bankruptcy Code § 724(b), 11 U.S.C. § 724(b), has the effect of abrogating a valid federal tax lien by making the property subject to that lien available first for the satisfaction of administrative expenses, wage claims, consumer creditors and other claims under § 507(a)(1)-(6). See also, *In re K.C. Machine & Tool Company*, 816 F.2d 238, 244 (6th Cir. 1987). Such claims generally are not permitted to be paid from property that is subject to a non-tax secured interest, see 11 U.S.C. § 725, but are payable at the expense of the IRS from a federal tax lien.

U.S.C. § 724(a). Completely valid federal tax liens are subordinated to administrative expenses and various other claims in Chapter 7 cases. *See* n.10, *supra*. Certain federal tax claims, which may be valid and enforceable in a non-bankruptcy setting, are fully dischargeable in a bankruptcy case. *See* 11 U.S.C. § 523(a)(1)(A)&(B)[11] and *In re Gerulis*, 56 Bankr. 283, 286 (Bankr. D. Minn. 1985). Like any other creditor, the United States can be sued for and required to return to the bankruptcy estate, pre-petition tax payments and transfers made to it that are found to be preferential under 11 U.S.C. § 547. *See Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). Like any other creditor, the United States can be required, in the exercise of the equity powers of a bankruptcy court, to marshall its federal tax claims against the debtor in a bankruptcy case. *In re Morahan, supra*; *In re Ann Arbor Brewing Co., supra*. *See also United States Fidelity & Guaranty Company* v. *Long*, 214 F.Supp. 307, 319 (D. Or. 1963) (". . . in the application of the [marshalling] doctrine, the United States and, accordingly its agencies, are on an equal basis with other creditors"). The United States, like any other creditor, can be required by the bankruptcy court to turn over to the debtor and bankruptcy estate property which the IRS seized and controlled before the filing of the bankruptcy petition. *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 209 (1983) ("We see no reason why a different result should obtain when the IRS is the creditor.") In large measure, as is obvious from this recitation, Congress (and where the result was not specifically codified — the courts) has determined that, in accordance with its notions of what is equitable, federal

[11] Under Bankruptcy Code § 523(a)(1)(A)&(B) various IRS claims covering periods three years before the bankruptcy petition date and longer are dischargeable even though those claims would otherwise be valid and collectible under the six year limitations period for collection of taxes in Internal Revenue Code § 6502(a).

tax claims should not be immune from the general buffeting of creditor claims and interests that takes place in bankruptcy cases in order to further important policy goals such as the reorganization of a debtor and the equitable distribution of money to the greatest number of creditors.

If the Government's view were correct that collection of federal tax claims is to take precedence over all other important goals Congress sought to achieve in bankruptcy cases, then Congress never would have enacted the provisions referred to above, and this Court, for example, would have allowed the IRS to keep the property it had seized in *Whiting Pools*, rather than direct that it be returned so the debtor could attempt to reorganize its affairs in Chapter 11. If Congress agreed with the Government's contention, it never would have allowed Chapter 11 plan proponents to pay a debtor's federal tax claims over a six year period of time, 11 U.S.C. § 1129(a)(9), but would have insisted instead that the IRS be paid in full incident to confirmation of a plan of reorganization.

The IRS objects to the test announced by the First Circuit and argues for the application of a strict *per se* rule under which an allocation of payments would *never* be permitted regardless of the circumstances of a case and how the interests of other creditors may be benefited therefrom. The Government's approach and suggested *per se* rule[12] should be rejected because it completely eliminates the opportunity to designate payments where it could be used to the advantage of the bankruptcy estate and creditors as a whole, without any significant corresponding risk to the IRS.

In its opinion, the court of appeals provided one example of how designation of payment can further the reorganization

[12] As the First Circuit noted (Government Petition at 20a), the *per se* rule suggested by the Petitioner was contained in a bill proposed in the House of Representatives, see H.R. 3984, 100th Cong., 2d Sess. § 201 (1988) (proposing an amendment to § 505 of the Bankruptcy Code), which was not enacted into law.

of a debtor, and thereby result in a greater distribution to all creditors (Government Petition at 13a-14a). In that example, third parties that included "responsible persons" under Internal Revenue Code § 6672, were willing to infuse enough money to rehabilitate the debtor corporation only if the bankruptcy court would assure them that under the plan of reorganization the reorganized company would pay its "trust fund" obligations first. Without that assurance, the "responsible persons" might well prefer the conversion of the case to Chapter 7 (liquidation) under which all priority tax debts (trust fund and non-trust fund) would be paid in full,[13] thereby relieving them of any liability under § 6672, but, at the same time, perhaps eliminating altogether any prospect for the general unsecured creditors receiving anything.[14] This is but one situation where the facts are such that the designation issue directly affects a debtor's rehabilitation and the interests of other creditors. Another example is where "responsible persons" who control the affairs of a corporate debtor and have either valid or contested claims against the debtor corporation might agree to reduce or eliminate those claims in exchange for the designation of plan payments to the IRS, thereby promoting a plan and increasing the dividend to other creditors; and, still another example is where they have (as such persons within a closely-held corporation often do) the special technical expertise that is essential to operate the affairs of the corporation and are persuaded (whether in the context of third party funding or otherwise) to continue in the business and assist in its rehabilitation, rather than converting the case to Chapter 7, provided payments under a plan of reorganization are so designated.

[13] Trust fund and non-trust fund taxes have the same priority for payment under Chapter 7,11 U.S.C. § 507(a)(7). Such obligations must be paid in full under the "absolute priority" rule of Chapter 7 before unsecured creditors, who have a lower priority, 11 U.S.C. § 726(a)(2), receive any payment.

[14] General unsecured creditors in a Chapter 11 case must receive at least as much in that case as they would have received in a Chapter 7 liquidation case, 11 U.S.C. § 1129(a)(7)(A)(ii); as a practical matter, they always receive significantly more because of their bargaining position and the preservation of going concern value. In addition, in Chapter 11 such creditors generally receive payments contemporaneously with taxing authorities holding priority claims, while in a Chapter 7 case they must wait until all assets have been liquidated and such priority claims paid in full before remaining funds, if any, can be paid to them.

E. *The test announced by the First Circuit does not conflict with any federal statutes or Congressional policies.*

The application of the court of appeals test creates no material conflict between the Bankruptcy Code and Internal Revenue Code, nor any of its regulations. Bankruptcy Code § 1129 (a)(9)(C) merely requires that in order for a plan of reorganization to be confirmed, it must provide for full payment of those taxes found to be due and owing under the Internal Revenue Code and accorded priority status under the Bankruptcy Code. Neither the language of, nor the policies behind, 11 U.S.C. § 1129(a)(9)(C) and Internal Revenue Code § 6672 [15] are in conflict on the issue of allocation of plan payments.

The collection of trust fund taxes under § 6672 is not impaired by the First Circuit's decision, and that court properly rejected outright the IRS's contention that its ruling somehow undermines the policy behind § 6672. (Government Petition at 17a-18a). Accepting a Congressional policy that "trust fund" taxes must be collected, § 6672 always remains, both prior to, during and after the corporate Chapter 11 filing, as an alternative source of collection of trust fund taxes for the IRS. There is nothing in the court of appeals opinion, nor anything else in the law, that removes § 6672 as an alternative source

[15] There is nothing in the Internal Revenue Code concerning allocation of payments. *In re Technical Knockout Graphics, Inc.*, 68 B.R. 463, 465 (9th Cir. B.A.P. 1986).

of collection. It has been held repeatedly that a corporate debtor's paying its trust fund taxes through a plan of reorganization does not exculpate "responsible persons" from their liability under § 6672 or permit them or their corporation to legally restrain the IRS from pursuing collection activities against them for whatever trust fund taxes are then owed. *See* Internal Revenue Code § 7421 ("Anti-Injunction Act"); *United States* v. *Huckabee Auto Co.*, 783 F.2d 1546 (11th Cir. 1986). This is a point that seemingly was overlooked in the three courts of appeals decisions which the Government asks this Court to follow. See *In re Ribs-R-Us, Inc.*, *supra*; *In re Technical Knockout Graphics, Inc.*, *supra* and *In re DuCharmes & Co.*, *supra*. In short, as the First Circuit observed, there is "nothing, including our opinion today" that in any way inhibits the IRS from proceeding against responsible persons under § 6672 as long as there are trust fund taxes owed. (Government Petition at 20a).

In objecting to the debtor's designation of plan payments, the IRS is not concerned about collection of trust fund taxes, but collection of taxes in total. It complains about the payment of taxes being subjected to the risk[16] of a plan failure, yet Congress has specifically provided that taxes can be subjected to such a risk by enacting Bankruptcy Code § 1129(a)(9)(C), which allows federal taxes to be paid out over a six-year period under a plan of reorganization. By advocating a *per se* rule under which plan payments would always be applied first to non-trust fund obligations, the IRS seeks to insulate non-trust

[16] The risks of plan failure the IRS refers to must be considered in light of the strict feasibility requirements that must be satisfied before a bankruptcy court will confirm a plan of reorganization and thereby let a debtor leave the "safe harbor" of Chapter 11. It is and should be difficult to meet the feasibility requirements of 11 U.S.C. § 1129(a)(11), as is demonstrated in the following cases, among many, where the courts were not persuaded and refused to confirm a proposed plan. *In re Clarkson*, 767 F.2d 417, 419-20 (8th Cir. 1985) and *In re Merrimack Valley Oil Co., Inc.*, 32 Bankr. 485, 487-91 (Bankr. D. Mass. 1983).

fund claims from the same risks that all other creditors with claims of like stature face under a Chapter 11 plan. The office of § 6672 is to provide for the collection of trust fund taxes, not all taxes. The IRS is attempting to use § 6672 to render the "responsible person" a guarantor of a debtor's *entire* tax obligation. By forcing the "responsible person" to be liable for the *last* tax dollars due from a debtor, the IRS is trying to extend a responsible person's liability to income, excise, and all other non-trust fund taxes, for which Congress never intended him to be personally liable. Indeed, the Government's argument is disingenuous because it permits a voluntary payment immediately prior to bankruptcy to be allocated to trust fund taxes regardless of how insolvent the corporate taxpayer may be. If anything, its argument is really one as to why *no* taxpayer should ever be permitted to designate allocation of a partial payment, a result which it not only has unequivocally failed to press under the common law but as to which its proper remedy lies in legislative change which it has yet to achieve.

Moreover, Congress could never have intended that the IRS would use § 6672 in such a way as to be given a right, which no other creditor has, to reduce, and, as periodically-made plan payments total the amount of the non-trust fund obligations, eliminate altogether the risk of non-payment of non-trust fund taxes under a plan. Through § 6672, Congress evidenced its great concern that trust fund taxes, not non-trust fund taxes, be paid, and that § 6672 be used toward that end, rather than "stood on its head", as the court of appeals observed (Government Petition at 18a), by elevating non-trust fund taxes to a super priority position over other claims.

In addition, not only is the IRS's policy of applying plan payments first to non-trust fund taxes inconsistent with the concern Congress has expressed for the collection of trust fund taxes, it is also completely at odds with another IRS policy, that § 6672 will be used "*only* when all other means of securing

the delinquent [trust fund] taxes have been exhausted."[17] *United States* v. *Sotelo*, 436 U.S. at 279-80, n. 12. That policy cannot be squared at all with the questionable policy of the IRS, in reliance on § 6672, intentionally to pass-up early plan payments of trust fund taxes, in favor of non-trust fund taxes.

[17] Although liability under § 6672 is often colloquially referred to as the "100% penalty," § 6672 does *not* impose a penalty, *United States* v. *Sotelo*, 436 U.S. 268 (1978), but is merely a tax collection tool, *Reid* v. *United States*, 558 F. Supp. 686, 688 (N.D. Miss. 1983), used to collect taxes against one who may have had no fraudulent or bad intent whatsoever, e.g. *McCarty* v. *United States*, 437 F.2d 961 (Ct. Cls. 1971), but who, faced with an unenviable Hobson's choice of (i) not paying employees or trade creditors, and thereby watching a salvageable business fold, or (ii) not paying the IRS with the hope that there will be money to pay taxes in the future, decides to pay employees and trade creditors. While such a decision renders one liable under § 6672, it hardly carries with it the moral opprobrium the Government seeks to ascribe to responsible persons.

Respondents do not in any way denigrate the seriousness of liability under § 6672, but must point out that the Government's contention that responsible persons have *actually* collected and withheld (Government Brief at 15) the taxes they may potentially be liable for under § 6672, and then "plundered" (Government Brief at 16) an *actual* fund of money held in trust and converted such monies for their "private use" (Government Brief at 15) is out of step with reality. As a review of a sampling of the legion of "100% penalty" cases would readily show, in the vast majority of cases the money to be withheld from payroll checks was simply never available and the corporate employer made a "net payroll." In addition, contrary to the tone of the IRS's brief, responsible persons are clearly not "getting away with something" when trust fund taxes are repaid by or on behalf of an employer who is the primary obligor of such taxes.

Conclusion

For the foregoing reasons, the opinion of the First Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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No. 89-255

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. Respondents' first argument seeks to defend the judgment below on a ground rejected by the court of appeals. Disagreeing with the court's holding that the bankruptcy court alone has the power to direct the IRS how to apply priority tax payments received under a Chapter 11 plan of reorganization, respondents argue that the debtor itself has that power. Therefore, respondents maintain, a Chapter 11 debtor can always require the IRS to apply priority tax payments first to the debtor's trust fund tax liability,

so as to minimize the Section 6672 liability of its responsible officers. See Resp. Br. 6-19. This argument is based on the related contentions that, under the IRS's own policy, the tax payments in question are "voluntary" and that, in any event, the debtor has a common law right to designate the application of such payments. Respondents' argument is flawed in several respects.

First, respondents are simply mistaken in asserting (Br. 17) that "the IRS's policy is based only upon its interpretation of common law principles pertaining to debtor/creditor relations." As we explain in our opening brief (at 19-20), the IRS's established policy, approved by several courts, has been to allow taxpayers to designate the application of "voluntary" payments, but not "involuntary" payments. While this distinction is in line with the common law treatment of voluntary payments from debtors to creditors, the IRS's policy is not determined by the contours of the common law. Rather, the policy is designed to encourage taxpayers to make voluntary payments, thereby sparing the government the risk and expense of pursuing its legal collection remedies. See *Amos* v. *Commissioner*, 47 T.C. 65, 70 (1966). Accordingly, although respondents erroneously suggest that the concept of an "involuntary" payment should be defined in terms of administrative seizures (see Resp. Br. 8-10), the recognized IRS rule has been to treat payments collected either by levy or through judicial proceedings as "involuntary" ones that are to be allocated among the taxpayer's debts as the IRS sees fit. See *Muntwyler* v. *United States*, 703 F.2d 1030, 1032-1033 (7th Cir. 1983); *Amos* v. *Commissioner*, 47 T.C. at 69.

As the court of appeals observed (Pet. App. 12a), the IRS is the best judge of the meaning of its own

rules, and the IRS has consistently regarded payments of priority taxes made under a Chapter 11 plan to be "involuntary" for these purposes. Thus, there clearly is no merit to the suggestion that the IRS's own internal policy requires it to accept a debtor's designation of Chapter 11 priority tax payments. Moreover, quite apart from the IRS's own interpretation, respondents' contention cannot be justified under the "voluntary"/"involuntary" dichotomy that has been approved by the courts. See U.S. Br. 20-25. Under the terms of Chapter 11, the debtor must make these priority tax payments as a condition of confirmation of its plan; thus, it is *forced* to make these payments in order to stave off liquidation, which hardly constitutes a "voluntary" payment. And this compulsion to pay the priority taxes is the product of a judicial proceeding. The debtor invokes the authority of the bankruptcy court; the debtor is both protected by, and required to pay priority taxes by, the confirmation plan with which the court has the power to compel compliance. Thus, the debtor's obligation to pay priority taxes under the plan is closely analogous to a taxpayer's liability upon a judgment in a tax collection suit, which, along with a collection by levy, is the prototypical "involuntary" payment to the IRS. See *Muntwyler* v. *United States*, 703 F.2d at 1033; *Amos* v. *Commissioner*, 47 T.C. at 69. In both situations, the obligation to pay is contained in an "express judicial order in a proceeding concerning the obligation in which both the debtor and the United States are parties." See *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 203 (3d Cir. 1987).[1]

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[1] Respondents are correct, of course, that payments are not "involuntary" simply because they are designed to satisfy a

Respondents argue (Br. 8, 10-14) that the payments in question are voluntary because Chapter 11 proceedings are designed to rehabilitate the debtor and offer it certain flexibility in paying its priority taxes and debts to other creditors. But this limited flexibility does not alter the fundamental reality that, once the plan is confirmed, the debtor is compelled by court order to pay its priority tax claims. Indeed, it is the same judicial proceeding that the debtor invokes to keep its creditors at bay during the rehabilitation process that compels it to pay the priority taxes in full. Accordingly, the courts of appeals have concluded that the limited control that a debtor is permitted to exercise under Chapter 11, subject to the dictates of the confirmation plan, does not mean that its priority tax payments should be regarded as "voluntary" and subject to designation. See U.S. Br. 20-21.

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legal obligation (see Resp. Br. 6-7); the rule permitting the designation of voluntary payments obviously is not addressed to gifts, but rather contemplates that the payments are to satisfy one or more of several enforceable debts. But that observation has no bearing on the treatment of payments under Chapter 11. The debtor has no choice but to make the payments of priority taxes as required by the plan of reorganization; it is compelled to do so by judicial order. The Chapter 11 payments thus are not induced merely by the "threat of enforced collection" (Resp. Br. 8) like voluntary pre-bankruptcy payments; rather, they are coerced by the bankruptcy court order enforcing the plan and the attendant statutory requirement that "the debtor * * * shall carry out the plan and shall comply with any orders of the court" (11 U.S.C. 1142(a)). Moreover, the policy underlying the IRS's rule, which is designed to encourage taxpayers to pay their taxes before they are compelled to do so by judicial process or other means of collection, would not be advanced at all by permitting the debtor to designate Chapter 11 payments.

Respondents also hesitantly suggest (Br. 18-19) that, in any event, a debtor has a common law right to designate payments of priority taxes under Chapter 11 because a correct interpretation of the common law "may" not reflect the voluntary payment rule. This argument, which is advanced primarily by cross-reference to the brief of amicus curiae GLK, Inc., is erroneous for several reasons. First, no reason is given why the common law treatment of payments between private debtors and creditors should necessarily control in this quite different context—where the payments in question are of tax liabiiities imposed by statute and for which Congress has provided the IRS with broad administrative collection powers. Second, there is no common law analogue to priority tax payments made pursuant to a Chapter 11 reorganization plan. A reorganized corporation, bound by the dictates of a confirmed Chapter 11 plan, is different in crucial respects from "a troubled corporation owning and controlling the funds" (Resp. Br. 19) from which a pre-bankruptcy payment is made.

Moreover, even if we accept as correct the common law rule that respondents purport to distill from two 19th century New York cases (see Resp. Br. 18), that rule lends no support to the claim that a debtor has authority to designate priority tax payments made pursuant to a Chapter 11 plan. Respondents suggest that a debtor who has "control over and ownership of the funds at the time of payment" has a right to designate how that payment should be applied (Resp. Br. 18; see also Amicus Br. 8). Respondents then argue that the Chapter 11 debtor exercises such control because the property of the estate is "revested in the debtor" under Chapter 11 following the confirmation of the plan (see 11 U.S.C.

1141(b)). But that does not cure the absence here of the only "control" that is relevant in this context —namely, the power of the debtor not to pay. Plainly, the basis for the debtor's power to designate the application of a voluntary payment (or one that it "controls") is its ability to insist upon the designation as a condition of payment. If the creditor refuses to accept the designation, the debtor can refuse to pay (thereby forcing the creditor to sue in order to collect). Compare 60 Am. Jur. 2d *Payment* § 95 (1987) ("The creditor has two choices: to apply the payment as directed, or to return the money to the debtor."). But the debtor that has sought the protection of Chapter 11 does not have the power to refuse to pay. Whatever latitude the debtor has to administer the property after it has revested, it is compelled by the court's confirmation order to make the tax payments set forth in the plan. The debtor thus lacks the necessary "control" to enable it to insist upon a particular allocation as a condition of payment. In sum, whether the right of a debtor to designate payments is viewed as turning on "voluntariness" or "control," the result is the same—a Chapter 11 debtor has no right to designate the application of priority tax payments made pursuant to a Chapter 11 plan.

2. Alternatively, respondents contend (Br. 19-25) that a court is always empowered to direct a creditor how to allocate among several debts a payment required by judicial order. This proposition, which if applied to tax collection would create a strong incentive for the government to forgo judicial collection methods in favor of administrative seizures, is flatly inconsistent with the established law upholding the IRS's policy of determining for itself the allocation of funds received in a collection suit. See U.S.

Br. 20; p. 2, *supra*.[2] The authority cited by respondents—three district court cases and two 19th century New York decisions—does not support their broad proposition, and it has no bearing on the question presented here.

First, as we have noted, there is no reason why common law principles governing private debtors and creditors should control resolution of the question presented here. Indeed, both the courts and the legal encyclopedia relied upon by the court of appeals below have recognized that, whatever the common law rule for private parties, the IRS has the power to determine how to apply tax payments received pursuant to court order. See, *e.g.*, *Amos* v. *Commissioner*, 47 T.C. at 69; 60 Am. Jur. 2d *Payment* § 104 (1987). Moreover, importation of the common law would be particularly inappropriate in the special context involved here, where the bankruptcy court's powers and the conduct of a Chapter 11 proceeding are governed by a detailed statutory code.

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[2] Respondents erroneously suggest (Br. 24-25) that the Tax Court's decision in *Amos* v. *Commissioner*, *supra*, supports such a rule. The language that respondents quote from *Amos*, however, is taken out of context. The Tax Court there (47 T.C. at 68 n.3) was discussing in a footnote a line of cases suggesting that a court has the power to determine the application of payments. The Tax Court proceeded to reject that line of cases, however, in favor of the contrary authority giving a creditor the right to determine how to apply involuntary payments. The Tax Court concluded that "the better rule for Federal tax purposes is to permit the Commissioner's agent to apply involuntary payments in the manner he chooses." The court defined an "involuntary payment" in this context as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." *Id.* at 69.

In any event, there is no established common law principle conferring upon courts the general power to direct the allocation of every payment that results from litigation.[3] The only reference to court authority in the oft-repeated statement by this Court of the rule governing allocation concerns the situation where both the debtor and the creditor have failed to specify an allocation and the question has subsequently come before the court. See U.S. Br. 26 & n.9; Resp. Br. 20-21. This statement suggests no general power in the court to override a creditor's preference in applying funds received pursuant to a court judgment in partial satisfaction of certain debts. To be sure, respondents do cite (Br. 22-23) some scattered cases that take the position that it is appropriate for a court to direct the allocation of payments, rather than permitting a creditor to make the allocation in its best interests, but these cases hardly reflect an established common law rule. Indeed, the lack of any consensus on this issue is explicitly noted in the decision that respondents and amicus (see Br. 9-11, 13-14) rely upon heavily for their rule, *Orleans County Nat'l Bank* v. *Moore*, 112 N.Y. 543, 20 N.E. 357 (1889). The court there commented that "the decisions of the common-law courts have been lamentably conflicting" on this point (112 N.Y. at 549; 20 N.E. at 359-360) and stated that it did not have room to list the "vast number of inconsistent and almost con-

[3] Contrary to respondents' contention (Br. 30-31), our position on this point is fully consistent with the IRS manual provisions instructing its personnel to allocate payments in accordance with applicable court orders. Recognizing the responsibility of government personnel to comply with court orders does not preclude the government from seeking to overturn on appeal those orders that are believed to be legally erroneous.

tradictory cases * * * upon this somewhat confused branch of the law" (112 N.Y. at 558; 20 N.E. at 364). Plainly, there is no broad common law principle that undermines the authority of the IRS to determine the allocation of taxes that it collects through judicial proceedings.[4]

Respondents also argue (Br. 21-22) that even the Tax Court's decision in *Amos* v. *Commissioner*, *supra*, indicates that a court cannot permit the IRS to allocate payments in its own discretion if "the interests of other creditors are affected." The cited footnote in *Amos* (47 T.C. at 70 n.5), however, is a narrow one, apparently designed to reserve judgment on the correctness of a prior district court decision,

[4] Moreover, even if they established a common law rule giving the bankruptcy court some power to designate the IRS's application of Chapter 11 priority tax payments, the lower court decisions upon which respondents rely still would not support the decision below. Respondents studiously avoid any attempt to derive from those decisions a workable standard to be applied by a court in exercising this broad power, suggesting only that the court should seek to advance "equity and justice" (Resp. Br. 21). But this Court has noted that the most significant factor to be applied by a court if it is called upon to make an equitable allocation is the relative precariousness of the various debts, and therefore that the allocation should be made to preserve the creditor's ability to collect its debts from other sources. See U.S. Br. 28; *Field* v. *Holland*, 10 U.S. (6 Cranch) 8, 28 (1810); see also *United States* v. *Transamerica Insurance Co.*, 357 F. Supp. 743, 748 (E.D. Va. 1973). The only other standard suggested in any of the cases cited by respondents is to apply the payment ratably to all debts. See *First Nat'l City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D. N.Y. 1977). Thus, no authority invoked by respondents lends any support to the idea that it is equitable for the court to apply the payment so as to *minimize* the creditor's ability to collect its debts, in order to confer a possible indirect benefit on other creditors.

Commercial Credit Corp. v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955). As we note in our opening brief (at 27 n.11), that case is quite different from the general situation addressed by respondents because it appears that the court there acted to prevent the IRS from taking improper action—*viz.*, applying the proceeds of a judicial sale to a tax debt secured by a lien junior to that of another creditor.

In any event, even if it were appropriate for a court to exercise designation authority in a broader class of cases where creditors would be adversely affected by the IRS's designation, that does not suggest that the power should be extended to a case like this one where the IRS's proposed designation has no direct effect on any creditor. Application of the Chapter 11 plan's tax payments first to non-trust fund taxes will not directly or inevitably affect the rights of creditors at all. No matter how the IRS applies the payments, the sums it receives under the plan, as well as the sums received by all other creditors, will remain the same. The only direct effect of the designation is to determine who bears the risk of an unsuccessful rehabilitation. As explained in our opening brief (at 16, 23-24), the IRS's proposed designation increases the possibility that the responsible persons' Section 6672 liability will survive if the plan is not completed; the court's proposed designation increases the possibility that the government will not be made whole for the debtor's priority tax delinquencies. But the responsible persons are not creditors of the corporate debtors whose interests the court arguably should weigh against the government's; they are third parties to the bankruptcy whose liability arises from their failure to discharge their statutory responsibilities. The only possible effect on the interests of other creditors resulting from the IRS's allocation policy is the indirect and speculative one that it may dampen the enthusiasm of the debtor's officers in assisting the debtor's rehabilitation. See Pet. App. 13a-14a. There is no suggestion in *Amos* or anywhere else that, when a creditor receives partial payment of several debts pursuant to court order, it should be forced to allocate that payment to its disadvantage and to the advantage of a third party in order to entice that third party to act—on the theory that other creditors might ultimately benefit from that action.

3. Respondents also defend (Br. 25-37) the court of appeals' holding that the Bankruptcy Code confers upon bankruptcy courts the authority to direct the IRS to allocate payments of priority taxes first to the debtor's trust fund liability in order to minimize the responsible persons' separate liability under Section 6672. Respondents appear to acknowledge (Br. 26) that 11 U.S.C. 105 is merely a procedural provision that does not give the bankruptcy courts the power to expand upon the substantive provisions of the Bankruptcy Code. They argue (Br. 26-27), however, that, in contrast to other orders that the courts have invalidated as beyond the scope of Section 105, this kind of designation order does not expand upon those substantive provisions. The basis for this asserted distinction is not apparent.

The Bankruptcy Code expressly states that full payment of all priority taxes must be provided for in the plan of reorganization. To the extent the payments only partially satisfy the outstanding priority tax debt, it would ordinarily be a matter of the IRS's own internal bookkeeping as to which portion of the debt remains unsatisfied. The Code does not expressly authorize the court to play any role in that

determination nor is there any reason to think that Congress impliedly established such a role, since that determination has no direct effect on the other parties to the reorganization. Nor does the Code generally authorize the court to take action in derogation of creditors' statutory rights for the purpose of assisting third parties who might thereby be persuaded to assist the reorganization. Thus, the designation order here does not "fall within the scope of the Code provisions expressly enacted" to govern the payment of priority taxes (see Resp. Br. 26), and it "fashion[s] an equitable right * * * broader than that contained in the Code" (see Resp. Br. 27). The bankruptcy court's order is not designed to "carry out" (11 U.S.C. 105) any substantive provision of the Code, and therefore it is not authorized by Section 105.[5]

Respondents dispute (Br. 31-37) the government's submission that the designation order approved here disrupts the balance struck by Congress between the general goal of rehabilitation and the specific gov-

[5] If it were necessary to carry out a specific provision of the Bankruptcy Code, we do not doubt that Section 105 would authorize the court to enter an order having the effect of limiting the IRS's ability to allocate a payment among different debts. Indeed, the Chapter 11 plan implicitly contains such a designation order. If the IRS attempted to apply priority tax payments made under a Chapter 11 plan to a tax debt that is not given priority under the Bankruptcy Code, clearly the bankruptcy court could take appropriate action. Cf. *Commercial Credit Corp.* v. *Schwartz, supra* (court prohibits funds collected on the basis of senior tax lien from being applied to debt secured by junior tax lien). But here there is no basis for the court to direct an allocation among the different priority tax delinquencies, all of which are required by statute to be paid under the plan of reorganization.

ernment interest in collection of priority tax delinquencies. See U.S. Br. 30-33. But respondents' argument is devoted entirely to demolishing a "straw-man"—namely, the assertion that "collection of federal tax claims is to take precedence over all other important goals Congress sought to achieve in bankruptcy cases" (Resp. Br. 35). We agree that such an assertion of complete primacy of federal tax claims would plainly be erroneous. As we note in our opening brief (at 32), Congress carefully balanced the competing interests of the debtor, the general creditors, and the taxing authorities. That balance is reflected in the specific provisions of the Bankruptcy Code. As respondents point out (Br. 33-35), there are numerous sections of the Code that specifically impair the interests of the taxing authorities. The existence of these specific limitations on the government's power to collect its taxes in bankruptcy lends no support, however, to the decision below; indeed, it emphasizes how the decision below departs from the balance struck by Congress.[6]

[6] Respondents' attempt (Br. 28-30) to defend the approach of the court below by reference to this Court's decision in *NLRB* v. *Bildisco & Bildisco*, 465 U.S. 513 (1984), is misguided. The Court there was interpreting a specific provision of the Bankruptcy Code (11 U.S.C. 365(a)), which explicitly authorizes the bankruptcy court to allow the debtor to reject an existing collective bargaining agreement. The Court determined that, because of the tension between that provision and the policies and requirements of the National Labor Relations Act, 29 U.S.C. 151 *et seq.*, Section 365(a) can be invoked only after the court has balanced the interests of the various affected parties. That holding concerning the correct standard to be applied in invoking the authority conferred by Section 365(a) plainly has no relevance here where there is no Bankruptcy Code provision that authorizes a court to designate the application of priority tax payments.

Just as Congress impaired certain interests of the taxing authorities in the Bankruptcy Code, it also expressly protected other interests, even at the expense of competing interests of the debtor and other creditors. Thus, it identified certain tax claims as priority tax claims for which full payment must be provided as a condition of confirmation of the plan of reorganization and which are not dischargeable in bankruptcy. See 11 U.S.C. 507(a)(7), 523(a), 1129(a)(9)(C). It is these interests preserved by Congress, not the ones impaired in the Bankruptcy Code, that are undermined by the designation order approved by the court below. As we explain in our opening brief (at 34-38), the designation order severely weakens the dual deterrent and revenue protection purposes of Section 6672 by enabling the responsible persons to use the corporate bankruptcy proceeding to reduce or eliminate their separate liability.[7] And the order frustrates the determination made by Congress in the Bankruptcy Code to promote full payment of priority taxes—by forcing the IRS to increase the risk of noncollection of those taxes, thereby jeopardizing the public fisc, in order to satisfy the financial demands of the responsible persons whose misconduct created the trust fund tax delinquency in the first place.

4. Apparently recognizing that the decision below permits a corporate Chapter 11 proceeding to be used as an instrument for benefitting the responsible persons at the expense of the public fisc, respondents

[7] The courts have consistently rejected various attempts of responsible persons to use corporate bankruptcy proceedings to shield themselves from Section 6672 liability, which would not be dischargeable in their personal bankruptcy proceeding. See U.S. Br. 35 & n.16. See also *American Bicycle Ass'n* v. *United States*, No. 88-15281 (9th Cir. Feb. 12, 1990).

seek to minimize the responsible persons' culpability and instead to portray them as positive agents in the reorganization. See Resp. Br. 40 n.17; see also Amicus Br. 24-25. According to respondents (Br. 40 n.17), the responsible persons do not act with "bad intent" in converting trust funds for the corporation's use; they simply take the logical step when faced with an "unenviable Hobson's choice" of "watching a salvageable business fold" or not paying the IRS. This characterization fails to recognize that Congress has prohibited responsible officers from making such a choice; "[t]he United States may not be made an unwilling joint venturer in the corporate enterprise" (*Mazo* v. *United States*, 591 F.2d 1151, 1154 (5th Cir.), cert. denied, 444 U.S. 842 (1979)). Rather than borrowing money from the government, a responsible person is bound to comply with his obligation to turn over trust funds to the IRS; if necessary, he may file a petition for reorganization in the bankruptcy court, claiming the protection against creditors available to a "salvageable business" under Chapter 11 of the Bankruptcy Code. An officer who instead dissipates the trust fund with payments to other creditors, in a futile effort to save his business, has deliberately violated his statutory responsibility, and is appropriately held liable under Section 6672 so that the public fisc may be made whole.[8] It is

[8] Respondents erroneously suggest (Br. 40 n.17) that the responsible persons have not converted public funds for the corporation's private use because all they have done is to make a "net payroll"; there is no "actual fund of money" that contains the withheld taxes. See also Amicus Br. 24 (taxes "'fictionally' withheld"). These persons have taken the government's money just as surely as if they had dipped into a trust fund bank account. When the "net payroll" is made, the employer reports that it has withheld the appro-

entirely inappropriate for the bankruptcy court to act to divert Chapter 11 payments from first satisfying the corporation's other priority tax delinquencies, which would lessen the burden on the public fisc (see U.S. Br. 33 n.14), and instead apply them so as to minimize the liability of these responsible persons.[9]

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priate amount of tax, and the government credits the employee with having paid that amount of tax. When the employee later files a tax return claiming a refund based on the "fictionally withheld" taxes, the government is required to pay a refund with real money. An employer in dire financial straits simply is not permitted to borrow money from the United States in this fashion. See U.S. Br. 32-33. If necessary, it must reduce payments to other creditors in order to satisfy its trust fund tax obligations. Thus, if the employer has only enough funds on hand to make a "net payroll," not to cover the withholding taxes, it is obliged to reduce the payments to employees so that the funds paid out will reflect a "gross payroll." See *Sorenson* v. *United States*, 521 F.2d 325, 328 (9th Cir. 1975).

[9] Respondents argue (Br. 35-37) that the designation order approved by the court below can aid the other creditors of the debtor by helping to avoid liquidation. Respondents posit three situations in which the responsible person yields something (money, a claim against the estate, or special technical expertise) for the assurance that trust fund taxes will be paid first. This assistance, argue respondents, will help other creditors because the bankruptcy proceedings will not be converted into liquidation proceedings, where general unsecured creditors have less likelihood of being paid. In short, respondents maintain that the persons who breached a statutory trust by paying withheld taxes to other creditors should be viewed as potential benefactors who must be wooed at the government's further expense. Respondents' argument, however, incorrectly suggests that it is the application of tax payments first to non-trust fund taxes that will drive the debtor into liquidation. Because the distributions to creditors remain the same regardless of the allocation of the tax payments, that allocation has no direct effect on the chances of successful rehabilitation. Of course, if the responsible persons withdraw their proffered support because the IRS declines to apply the payments in a manner that minimizes their Section 6672 liability, the debtor's chances of successfully reorganizing might be adversely affected. In that event, however, the specter of liquidation comes not from the IRS's allocation, but rather from the threats of the responsible persons, who are essentially seeking to hold the debtor's successful rehabilitation hostage to their demand for a personal accommodation with respect to their Section 6672 liability.

For the foregoing reasons, and those stated in our opening brief, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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Solicitor General

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